2000

Auto dealership industry developments - 2000/01; Audit risk alerts

American Institute of Certified Public Accountants

AUDIT RISK ALERTS

Auto Dealership Industry Developments—2000/01

AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS

AICPA

Notice to Readers

This Audit Risk Alert is intended to provide auditors with an overview of recent economic, technical, and professional developments that may affect the audits they perform. This document has been prepared by the AICPA staff. It has not been approved, disapproved, or otherwise acted on by any senior technical committee of the AICPA.

Linda Delahanty
Technical Manager
Accounting and Auditing Publications

The staff of the AICPA is grateful to Jacob J. Cohen, CPA, for his contributions to this Alert.

1 2 3 4 5 6 7 8 9 0 AAG 0 9 8 7 6 5 4 3 2 1 0

In This Year's Alert…

On the Horizon

- *What exposure drafts are currently outstanding? Page 64*

Beyond the Audit

- *What are Assurance Services Alerts? Page 69*

Resource Central

- *How can I order AICPA products? What other AICPA services may be of interest to me? Page 71*

Table of Contents

Auto Dealership Industry Developments—2000/01

Introduction

What is the purpose of this Audit Risk Alert?

This Audit Risk Alert is intended to help auditors plan their 2000 year-end audits of dealerships. Although this Alert focuses on the automobile dealership, the topics discussed often can be applied to other types of dealerships, including boats, heavy trucks, farm machinery, and recreational vehicles. Keep in mind that a successful audit begins with successful planning. A thorough understanding of the requirements of Statement on Auditing Standards (SAS) No. 22, *Planning and Supervision* (AICPA, *Professional Standards*, vol. 1, AU sec. 311), will go a long way to developing an effective and efficient audit strategy. Some of the requirements of the SAS include the auditor's consideration of matters that relate to the entity's business, including those affecting the industry in which it operates, economic conditions, government regulations, and changes in technology.

Economic Developments

How did dealerships do since our last Alert? What are the current economic conditions facing dealerships?

Auditors should be aware of the general economic, regulatory, and professional developments that may affect the audits they perform. See *Audit Risk Alert—2000/01* (Product No. 022260kk) for a summary of general economic conditions. Also keep in mind that SAS No. 56, *Analytical Procedures* (AICPA, *Professional Standards*, vol. 1, AU sec. 329), requires the use of analytical procedures in the planning and overall review stages of all audits. Statistical information of the type shown may be useful to auditors in applying the provisions of SAS No. 56.

Dealership Results

Auto dealerships continue to play an important role in the extraordinary growth of the U.S. economy. Franchised new vehicle dealers continued to break sales records in 1999. Total industry revenue reached a record of more than $608 billion, with more than 16 million new cars and light trucks registered in the United States.[1] Before 1998, dealership profits came mostly from the sale of used vehicles and the service and parts department. In 1999, the new vehicle department became a major contributor to total dealership profit, contributing 39 percent to total profit at the average dealership. This is up from almost 30 percent in 1998. In 1999 sales of new vehicles increased 14 percent from 1998 and used vehicle sales increased 10 percent, with total sales of 20.1 million used cars.[2]

Although consolidations have slowed, small-volume franchised car dealerships continued to decline in 1999. This is nothing new to the dealership industry because the number of small-volume dealerships has been declining steadily for more than a decade. According to *Automotive Executive Magazine*, in 1980 more than 10,600 dealerships had fewer than 150 new vehicle sales per year; today there are only 4,161 such dealerships (this is down from 4,256 last year). In contrast, today more than 5,800 dealerships sell more than 750 new vehicles per year, whereas fewer than 4,000 such dealerships existed in 1980.[3]

The Current Economic Environment

Once again, the U.S. economy put in an impressive performance. The longest economic expansion in the nation's history has maintained strong momentum in the first half of 2000, continuing the rapid rate of growth that prevailed during the second half of 1999. Dealers continued to benefit from the strong economy. Given the interrelationship of automobile sales and the economy, auditors of dealerships will benefit from having an understanding of general

1. *Automotive Executive Magazine, NADA Data 2000* (August 2000): 29-59.

2. See footnote 1.

3. *Automotive Executive Magazine, NADA Data 1995*: 29; and *NADA Data 1998* and *NADA Data 2000*.

economic conditions. The strong historical relationship between consumer confidence and automobile sales continues.

Overall, 2000 has been characterized by vigorous consumer spending, surging capital investment in new, cost-saving technologies, rising levels of worker productivity, and historically low rates of unemployment. Dealerships continue to play a major role in the nation's employment. In 1999 the payroll for all dealerships combined represented 11 percent of the nation's total retail trade payroll.[4]

There were, however, some signs suggesting that a moderation in economic growth may be on the horizon. Inflation, for instance, though still moderate, increased over 1999 levels. Interest rates were also on the rise, driven by the Federal Reserve Bank's anti-inflation strategy that raised the federal funds rate (the interest rate at which banks lend to each other overnight) almost two percentage points over 1999. Even though the economy shows signs of moderating, sales of automobiles are expected to break records again in 2000.

SAS No. 56 requires the use of analytical procedures in the planning and overall review stages of all audits. The following key statistics relating to the overall performance of the U.S. economy may be useful to auditors in applying the provisions of SAS No. 56.

- Gross domestic product (GDP)—which measures the output of goods and services produced by labor and property located in the United States—increased at a rate of 4.8 percent in the first quarter of 2000. GDP then rose to 5.6 percent in the second quarter of 2000. Estimates for third-quarter GDP suggest that the economy has slowed to a growth rate in the 3 percent range. Estimated annualized GDP for 2000 is 4.5 percent.
- Consumer confidence,[5] a key predictor of household spending, reached a record high of 144.7 first in January and then again in May before moderating a bit to 141.9 in

4. *Automotive Executive Magazine, NADA Data 2000*: 48.

5. As measured by the Conference Board. See www.conferenceboard.org for further information.

September. During the first quarter of 2000, personal consumption expenditures rose at an annualized rate of 7.75 percent, the sharpest increase since 1983. That rate declined to 3.1 percent in the second quarter. Historically, there appears to be a strong relationship between consumer confidence and automobile sales. With consumer confidence remaining high, 2000 may yet again be a record-setting year.

- Unemployment hovered around 4 percent for much of the year, dropping to 3.9 percent in April and September, a thirty-year low. Inflation, though on the rise, remained low at an annualized estimate of under 3 percent.
- The Dow Jones Industrial Average (DJIA) climbed to 11,500, and the National Association of Securities Dealers Automated Quotation (NASDAQ) to 5,000. However, both indexes experienced precipitous declines from those heights during 2000 as the bottom dropped out of a number of business sectors. Most notable among them were the "new economy" stocks. The market did begin a slow recovery, but periods of price volatility continued. The stock of publicly held dealerships continues to underperform. (See the section "Publicly Held Dealership Groups" in this Audit Risk Alert for a further discussion on these types of dealerships.)
- Interest rates inched up during the year but still remained near historically moderate levels. By the end of the third quarter, the prime rate (the rate many banks charge their top customers and to which other interest rates are often linked) reached 9.5 percent, and thirty-year fixed mortgage rates generally remained under 8 percent. The Federal Reserve raised its federal funds rate during 2000, reaching 6.5 percent by the third quarter. Keep in mind that dealerships are generally highly leveraged. As interest rates rise, auditors should pay closer attention to dealership debt. (See the section "Inventory and Notes Payable Under Floor Plan Arrangements" for a further discussion of these significant balance sheet items.) Another item to

note is that when interest rates rise, historically there is a corresponding decrease in vehicle sales.

The general consensus is that the current economic expansion is expected to continue through next year, but at a more moderate pace.[6]

In addition to the national economy, auditors should also consider the local economy. Significant local developments may affect dealership performance. Certain regions may be vulnerable to economic downturns in major local industries, whereas other regions may be susceptible to various natural disasters.

Executive Summary—Economic Developments

- Sales records were broken again in 1999, with total dollar sales of all franchised new car dealerships rising to a record $608 billion.
- The new vehicle department became a major contributor to total dealership profits.
- The number of small-volume franchised car dealerships continues to decline.
- The U.S. economy continues its longest economic expansion in its history.
- There are some signs that the economy may be moderating, but vehicle sales remain strong.

Industry Developments and Other Issues

What are some significant industry developments facing dealers?

Dealers continue to benefit from the strong U.S economy. Two areas on which the National Automobile Dealership Association[7] (NADA) intends to focus its efforts are industry relations, including

6. For a further discussion of the U.S. economy in general, see *Audit Risk Alert 2000/01* (Product No. 022260kk).

7. The NADA is a not-for-profit organization promoting the interests of American franchised new car and truck dealers in the United States. Among their activities, the NADA publishes a monthly magazine, used car valuation guides, and other information on various aspects of dealerships. The NADA also represents dealers on Capitol Hill. For more information about the NADA, visit their Web site at www.nada.org.

the relationship between the factories and the dealers, and electronic commerce (e-commerce).[8] The following sections touch on these areas.

Competition

What threats do dealers face today?

As noted earlier, when planning the audit, auditors should consider SAS No. 22, *Planning and Supervision*. SAS No. 22 states that, when planning an audit, the auditor should consider other matters, such as accounting practices common to the industry, competitive conditions, and if available, financial trends and ratios. In addition, SAS No. 82, *Consideration of Fraud in a Financial Statement Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 316), indicates that the presence of a high degree of competition or market saturation, accompanied by declining margins, may indicate an increased risk of fraudulent financial reporting. Keep in mind that when risk factors are identified, professional judgment should be exercised when assessing their significance and relevance (see SAS No. 82 for a list of additional fraud risk factors). Auditors should also keep in mind their responsibilities under SAS No. 59, *The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern* (AICPA, *Professional Standards*, vol. 1, AU sec. 341). SAS No. 59 discusses the auditor's responsibilities when there is substantial doubt about an entity's ability to continue as a going concern. Some external matters cited by SAS No. 59 that could indicate there is substantial doubt about the entity's ability to continue as a going concern when considered in the aggregate include loss of a key franchise and loss of a principal customer or supplier.

The auto dealership industry is considered a mature industry with intense competition. The threats to the traditional "brick and mortar" franchised dealership are not just from other traditional dealerships but from bytes and mouse clicks. Although franchised dealers continue to compete with used-car superstores

8. *Automotive Executive Magazine*, March 2000: 9.

and public dealership groups, the impact of the Internet may yet be the biggest challenge they face. The Internet has the potential to change the way that cars are sold. E-commerce is here to stay, and even though the Internet may make the dealership industry a lot more competitive and challenging, if used effectively it could also give dealers a competitive edge. A recent study found that over 80 percent of car buyers were satisfied with their car buying experience through the dealership network. As dealerships continue to create their own Internet Web sites they are effectively competing with the other dot-com sites. In fact, according to the NADA, dealerships that have had Web sites for several years are generating 20 percent of their new vehicle sales from the Internet. To stay competitive, dealers need to establish a Web presence, and some even predict that for dealers to survive they need to have strong, effective Web sites. You should consider the implications if your client does not have a Web site or if he or she is not using it effectively. For a further discussion of the use of the Internet and e-commerce, see the section “In Focus: The Internet” in this Audit Risk Alert.

Relationship With Factories

Another area of continued concern is the relationship between the dealership and its factory.[9] In fact, the NADA continues to focus on industry relations, such as the impact of factory-owned or -controlled dealerships. With the threat of factory-dealer partnerships and manufacturer Web sites, dealers are now finding themselves in competition with their own factories. In last year’s Alert we discussed the General Motors Corporation (GM) strike and its effect on GM dealerships. In addition, the NADA took a strong stand against factory-owned or -controlled dealerships. You should also be alert to an emerging trend toward the establishment of factory Web sites that link with their franchised dealerships. (For a further discussion, see the section “In Focus: The Internet” in this Audit Risk Alert.)

9. For the purposes of this section, the word *factories* is synonymous with *manufacturers*.

Because factories can exert tremendous pressure on a dealer, during the planning of the audit, auditors may wish to inquire about the dealer's relationship with the factory. Auditors can look to the dealership's customer satisfaction index (CSI), which evaluates customer service performance via a poll performed by the manufacturer, and its service satisfaction index (SSI), which is similar to CSI. The auditor also may inquire whether the dealership has been receiving proper inventory allotments, whether the factory has indicated any desire for leasehold improvements or major renovations to the dealership facilities, whether the factory is suggesting any realignment of products to meet factory desires, or whether the factory has requested the dealership to move its location, and if applicable, whether the dealership is in compliance with factory standards for working capital and equity.

Auditors should pay attention to the dealership—factory relationship because it can have a tremendous impact on the dealership. In some cases, adverse relationships may affect the dealership's ability to continue as a going concern—for instance, if the dealer cannot meet customer demands because it is unable to obtain certain types of vehicles from the factory. In reviewing such relationships, auditors should be aware of their responsibilities pursuant to SAS No. 59, *The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern*. SAS No. 59 says that ordinarily information that significantly contradicts the going-concern assumption includes the inability to continue to meet obligations as they become due without substantial disposition of assets outside the ordinary course of business, externally forced revisions of operations, or similar actions. Auditors also should consider whether management has made appropriate financial statement disclosures of concentrations in the available source of supply materials pursuant to Statement of Position (SOP) No. 94-6, *Disclosure of Certain Significant Risks and Uncertainties*.

The following list includes other situations of potential conflict that could adversely affect the relationship between the dealer and the factory:

- *Factory-owned or -controlled dealerships.* As discussed earlier, factory-dealer partnerships continue to be a concern for the NADA.
- *Product recalls.* The current recalls at Ford Motor Company (Ford) both for certain vehicles and for those fitted with Firestone tires show how dealerships must rely on the reputation of their factory. Such recalls could have a negative impact on dealership profits. Many customers are shying away from purchasing affected vehicles altogether, and others will demand different brands of tires, even on those models not involved in the recall. Dealers are incurring additional costs to keep their customers happy, and these costs may be paid for by the dealer. How manufacturers handle these issues may have a direct impact on their franchised dealerships. In fact, some suggest that dealers are agents of the manufacturer and therefore could have some liability related to recalls. Auditors should continue to monitor the developments of this situation. If your client is involved in a recall situation you may want to consider the impact the recall has on dealership inventory and on the collectibility of factory warranties. For example, with the recent tire recall involving Ford dealerships, the reallocation of resources to provide replacement tires may cause a shortage in inventory. In addition, some of the costs incurred by dealers to make their customers happy may not qualify for reimbursement by the manufacturer under the warranty agreement. An emerging trend is the audit of warranty claims, by the factories. Often the factory audits dealership warranty claims, and if the dealership cannot prove the need for the repair, the factory may charge the dealership for that repair. Auditors should be alert to the potential for a charge back to the dealership for warranties.
- *Mandatory arbitration.* Recently, dealers have testified on Capitol Hill that manufacturers are trying to circumvent state laws by including mandatory arbitration clauses in dealer agreements to resolve disputes. The NADA believes that mandatory arbitration gives manufacturers economic

leverage over their dealers and would like to see voluntary arbitration allowed. (For more information on the voluntary arbitration bill (H.R. 534) that was recently passed by the U.S. House of Representatives you can go to the NADA's Web site at www.nada.org.)

- *Blue Oval Program*. Ford's recent announcement of the Blue Oval dealer certification program created conflict between Ford dealers and the company. This program would certify and reward certain dealers. There is belief that this program could place some Ford dealerships at a competitive disadvantage.
- *Standalone franchises*. The relationship between a factory and its dealership takes on greater importance when the dealership has only one franchise (standalone franchise) or brand of vehicle. In this case the dealership would be dependent upon that factory for its existence. For example, it has been predicted that Ford will discontinue the "Mercury" brand because there are no planned introductions for this line of vehicles after 2001. In such situations, auditors should consider the responsibilities under SAS No. 59, *The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern*. In addition, auditors should consider whether management has made appropriate financial statement disclosures of such concentrations in the available source of supply materials pursuant to SOP No. 94-6, *Disclosure of Certain Significant Risks and Uncertainties*.

Publicly Held Dealership Groups

The most prevalent form of auto dealership is the franchised dealership, where a vehicle manufacturer gives the dealership the right to market its vehicles through a franchise agreement. Franchised dealerships may be publicly held or independent. Typically, the publicly held dealerships were once independent dealerships that were purchased and consolidated into retail chains. A trend in the industry was for these retail chains to go public. Although publicly held dealership groups are still a concern for franchised dealerships, these groups have slowed down their merger and acquisitions activity. This slowdown can be attributed to various causes, such as depressed stock prices, which force public dealerships to pay for acquisitions in cash or to guarantee their stock price for a period of time. In addition, the rise in interest rates and the uncertainty of the effect the Internet will have on the industry have kept these groups from continuing their aggressive acquisition campaign. Many of these large groups need time to assimilate the dealerships they have already acquired. Others are changing their focus to improving their existing operations rather than continuing to aggressively purchase more dealerships. Even with the DJIA breaking the 11,000 mark and historical sales of automobiles in 1999, the stocks of publicly held dealership groups such as AutoNation, Inc.; Group 1 Automotive, Inc.; Lithia Motors, Inc.; and Sonic Automotive, Inc. continue to underperform. Many believe that until dealerships prove that they can remain profitable during a downturn in the economy, investors will continue to shy away from such stocks.

Other Issues

What should you know about money laundering?

Money Laundering[10]

Money laundering is the funneling of cash or other funds generated from illegal activities through legitimate financial institutions (and automobile dealerships are defined as non-bank financial institutions by the Bank Secrecy Act[11]) or other businesses to conceal the initial source of the funds. Money laundering is a global activity and, like the illegal activities that give it sustenance, it seldom respects local, national, or international boundaries. Current estimates of the size of the global annual "gross money laundering product" range from $500 billion to $1 trillion.[12]

10. This section of the Alert was drafted after consultation with the U.S. Department of the Treasury. As such, it provides auditors with a unique insight into how federal regulators view this important area of concern.

11. 31 U.S.C. 315312(a)(2)(T).

12. By definition, money launderers are in the business of cloaking their activities and revenue, making this approximation difficult.

Criminals use a wide variety of bank and non-bank financial institutions and professional advisers to launder the proceeds of crime, and according to the U.S. Department of Treasury, auto dealerships and dealers in boats and aircraft may also be vulnerable. As money launderers increasingly look for a wide range of financial services and conservative, legitimate-appearing asset holdings, and as greater regulatory requirements for banks and other non-bank financial institutions make it more difficult for them to evade detection, the automobile dealership industry may become increasingly vulnerable to money laundering and more attractive to money launderers.

Although automobile dealerships are not subject to anti-money laundering regulations under the Bank Secrecy Act, regulations issued by the Internal Revenue Service (IRS) require these businesses to report the receipt of currency and certain monetary instruments that exceed $10,000. Section 6050I of the Internal Revenue Code requires that any person who, in the course of engaging in a trade or business, receives more than $10,000 in cash or, in some instances, monetary instruments, in a single transaction or two or more related transactions, must file a report describing the transaction or transactions.[13] This requirement does not apply to transactions that are reported under the Bank Secrecy Act to avoid duplicated reporting of the same transaction.

As money laundering activities and methods become increasingly complex and ingenious, its "operations" tend to consist of three basic stages or processes—placement, layering, and integration.

Placement is the process of transferring the actual criminal proceeds, whether in cash or in any other form, into the financial system in such a manner to avoid detection by bank and non-bank financial institutions and government authorities. Money launderers pay careful attention to national laws, regulations, governance, trends, and law enforcement strategies and techniques in order to keep their proceeds concealed, their methods

13. See 26 U.S.C. 6050I. The report must include the following information: the name, address, and taxpayer identification number of the person from whom the cash was received; the amount of cash received; the date and nature of the transaction; and such other information as may be prescribed by rule.

secret, and their identities and professional resources anonymous. A common placement technique is to purchase expensive luxury goods, often through structuring[14] payments of illicitly obtained cash and cash equivalents.

Layering is the process of generating a series or layers of transactions to distance the proceeds from their illegal source and to obfuscate the audit trail in doing so. Common layering techniques include electronic fund transfers, usually directly or subsequently transacted with a "bank secrecy haven" or a jurisdiction with more liberal recordkeeping and reporting requirements; withdrawals of already-placed deposits in the form of highly liquid monetary instruments, such as money orders and travelers checks; and requests for account transfers or checks made payable to third parties with whom the account holder or policy holder appears to have no obvious relationship.

Integration, the final money laundering stage, is the unnoticed reinsertion of successfully laundered, untraceable proceeds into an economy. This is accomplished through a wide variety of spending, investing, and lending techniques and cross-border, legitimate-appearing transactions.

Money launderers tend to use the victimized business entity as a conduit for illicit funds that need to be distanced from their source as quickly as possible in an undetected manner. Consequently, money laundering is far less likely to be detected in a financial statement audit than other types of illegal activities. In addition, money laundering activity is more likely to cause assets to be overstated rather than understated, with shorter-term fluctuations in account balances rather than cumulative changes. Money laundering is considered to be an illegal act with an *indirect* effect on financial statement amounts under SAS No. 54, *Illegal Acts by Clients* (AICPA, *Professional Standards*, vol. 1, AU sec. 317). Under SAS No. 54, the auditor should be aware of the possibility that such illegal acts may have occurred. If specific

14. *Structuring* means breaking up large amounts of currency into smaller amounts to conduct transactions in such a manner to avoid currency reporting or other regulatory requirements.

information comes to the auditor's attention that provides evidence concerning the existence of possible illegal acts that could have a material indirect effect on the financial statements, the auditor should apply audit procedures specifically directed to ascertaining whether an illegal act has occurred.

Auditors should also note that laundered funds and their proceeds could be subject to asset seizure and forfeiture (claims) by law enforcement agencies that could result in material contingent liabilities during prosecution and adjudication of cases.

In June 2000, the OECD's Paris-based Financial Action Task Force (FATF), the world's anti-money laundering watchdog intergovernmental organization, issued a *Review to Identify Non-Cooperative Countries or Territories*, expressly identifying fifteen governments as noncooperative with other countries and jurisdictions in combating money laundering. Subsequently, in July, the U.S. Treasury Department followed suit with a series of Financial Crimes Enforcement Network (FinCEN) country advisories, which asked U.S. businesses to pay closer attention to transactions linked to these countries.

> **Help Desk**—A description of federal regulations pertaining to money laundering appears in this Alert's appendix, *Federal Regulations Related to Money Laundering*.

Executive Summary—Industry Developments and Other Issues

- The auto dealership industry has intense competition and the threats to the traditional brick-and mortar franchised dealership are not just from other traditional dealerships but from bytes and mouse clicks.
- The Internet has the potential to change the way that cars are sold.
- Although the Internet increases competition, it may also give dealers a competitive edge. Is your client online or being left behind?
- How is the relationship between your client and its factory? The relationship between the dealer and its factories could have a tremendous impact on the dealership.

How is the Internet affecting dealerships?

The effect of the Internet on franchised dealerships is still emerging. What has become apparent is that the brick-and-mortar dealerships are still going strong. A recent survey by the NADA showed that over 80 percent of dealerships now have Web sites, with 98 percent of those Web sites being interactive. Dealers are using their Web sites to market their products and to interact with customers. Some interactive features include allowing customers to send e-mails, order online, schedule sales and service appointments, or obtain financing. A recent survey[15] showed that 48 percent of car buyers used the Internet to research or actually purchase a vehicle. This is up from 25 percent from two years ago. J.D. Power & Associates predicts that by the end of this year, 65 percent of all car buyers will use the Internet as a prepurchase research tool. In addition, the Internet is being used by factories and dealerships to help conduct business between themselves (business-to-business). With many traditional brick-and-mortar dealerships expanding their traditional business into this new environment of the Internet, auditors are faced with new issues. Transactions conducted in an e-commerce environment may have a significant impact on the audit process.

> **Help Desk**—If your client is a dot-com company, see the electronic business (e-business) section of the Audit Risk Alert, *Industry Developments—2000/01*, for a discussion of the auditor considerations in such an environment. Look also for the newly introduced Audit Risk Alert *E-Business Industry Developments—2000/01* for comprehensive discussions of the audit considerations unique to the e-business environment. See "Resource Central" later in this Alert for further information.

In addition to dealer Web sites, there are many other Web sites for buying and selling new and used cars. Manufacturers continue to try to establish an Internet presence by selling directly to consumers through the Internet. Because of the franchise laws in

15. Survey by the Gartner Group.

many states, however, some manufacturers have been kept offline for the time being. Ford is currently appealing a court ruling in Texas that prevents Ford from selling cars directly to online shoppers. A Texas state law prohibits factories from acting as dealers. In Arizona a law was introduced that would restrict how car manufacturers market and sell their vehicles over the Internet. In fact, almost forty states already have laws prohibiting manufacturers from selling vehicles directly to customers, and there is legislation being introduced in many states to strengthen their existing franchise laws.

Other manufacturers are taking a different approach to the Internet. To compete with Internet buying services, GM recently proposed a joint venture with its dealers to establish a Web site that would sell cars and trucks over the Web. It would connect GM dealers directly with customers at an independent Web site. Ford also has said that it will partner with its dealers to form www.forddirect.com, an Internet site that allows customers not just to buy a car online, but actually to configure, price, and finance it before making a purchase.

Numerous other dot-com companies are selling cars: www.autobytel.com, www.autoconnect.com, www.autoweb.com, and www.autovantage.com, to name just a few. This past year, however, has been difficult for many of the dot-com car sites. Some of these Web sites earn most of their revenue from fees charged to participating dealers for referrals. Of late, such dot-com companies are losing more of their participating dealers than they are adding, often because the dealer Web sites are becoming more sophisticated and no longer need the referral services.

In addition, some manufacturers are prohibiting their dealers from selling new vehicles to entities that engage in brokering. This is being done through their franchise agreements. One online broker has ceased taking orders and is now looking to acquire traditional brick-and-mortar dealerships. These dot-com companies are finding that dealerships are still an integral part of the car-buying process. Before 1998, new car sales had not been profitable to dealerships. Dealerships looked to other areas, such as used car sales, the financing and insurance departments, and the parts and service departments, to increase profits. Without full-scale operations, it is very difficult for a dealership to be profitable. The dot-com companies that acted strictly as brokers between customers and dealers found it very difficult to sell cars because they were not dealers themselves. Issues arose, such as how to trade-in a car, how to test drive a car, and how to obtain financing (especially a more complicated financing, such as when the customer wants to trade in a car that is not fully paid for and wants to roll the remaining balance of the old loan into the new financing). All these factors and more have kept the traditional dealerships alive and well.

Another area of continued development is the use of the Internet for business-to-business transactions. Not only are many dealerships connected with the factories via electronic systems for vehicles, parts, and warranty claims, but many manufacturers are now using systems to allow their dealers to order, trade, or locate cars online. These Internet-based systems allow for access to dealer data, dealer-factory communications, and competitive sales data. In fact, DaimlerChrysler Corp. recently launched a nationwide Internet-based marketplace (Five Star Market Center) for its dealers.

Dealers may face certain exposures when conducting business via the Internet. Such exposures include unauthorized access to or theft of data (customer information), computer viruses, and unauthorized transactions. The use of the Internet by auto dealerships raises numerous auditing and accounting issues that must be considered by auditors.

Accounting and Auditing Standards to Consider

According to SAS No. 55, *Consideration of Internal Control in a Financial Statement Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 319), as amended by SAS No. 78, *Consideration of Internal Control in a Financial Statement Audit: An Amendment to SAS No. 55* (AICPA, *Professional Standards*, vol. 1, AU sec. 319), auditors should obtain an understanding of internal control sufficient to plan the audit. After obtaining the understanding, you should assess control risk. Both the understanding and the basis for conclusions about the assessed level of control risk should be documented.[16] In the planning phase, your understanding of the client's internal control should be used to identify types of potential misstatements, consider factors that affect the risk of material misstatement, and design substantive tests. Risks relevant to financial reporting include external and internal events and circumstances that may occur and adversely affect an entity's ability to record, process, summarize, and report financial data consistent with the assertions of management in the financial statements. SAS No. 55 says that risks can arise or change due to various circumstances including new or revamped information systems, rapid growth, new technology, new lines, products, or activities. In light of the recent movement to the use of the Internet, SAS No. 55 takes on greater importance.[17]

SAS No. 31, *Evidential Matter* (AICPA, *Professional Standards*, vol. 1, AU sec. 326), as amended by SAS No. 80, *Amendment to Statement on Auditing Standards No. 31*, Evidential Matter (AICPA, *Professional Standards*, vol. 1, AU sec. 326), provides guidance for auditors who have been engaged to audit an entity's financial statements when significant information is transmitted, processed, maintained, or accessed electronically. The AICPA Auditing Practice Release *The Information Technology Age: Evidential Matter in the Electronic Environment* provides additional guidance on applying SAS No. 31 in the audit of financial statements of an entity where significant information is transmitted, processed, maintained, or accessed electronically.

SAS No. 1, *Codification of Auditing Standards and Procedures* (AICPA, *Professional Standards*, vol. 1, AU sec. 210.01, "Training and Proficiency of the Independent Auditor"), states that the audit is to be performed by a person or persons having adequate technical training and proficiency as an auditor. With that guidance in

16. However, for those financial statement assertions where control risk is assessed at the maximum level, the auditor should document his or her conclusion that control risk is at the maximum level but not document the basis for that conclusion.

17. In October 2000 the ASB issued an exposure draft of a proposed SAS to amend SAS No. 55 to provide guidance to auditors about the effect of information technology on internal control, and on the auditor's understanding of internal control and assessment of control risk. See the section "ASB Exposure Draft" of this Audit Risk Alert for further details.

mind, you need to consider that electronic evidence may exist in a form that demands specialized skills to access and interpret. Auditors without such skills are likely to require the assistance of a specialist. SAS No. 73, *Using the Work of a Specialist* (AICPA, *Professional Standards*, vol. 1, sec. AU 336), provides guidance if a technology specialist is necessary on an engagement.

If a client's e-commerce transactions are processed by an outside Internet service provider, you may need to consider the guidance in SAS No. 70, *Service Organizations* (AICPA, *Professional Standards*, vol. 1, AU sec. 324).

The Financial Accounting Standards Board (FASB) Emerging Issues Task Force (EITF) Issue No. 00-2, *Accounting for Web Site Development Costs*, provides guidance on how the costs incurred in developing a Web site should be accounted for. It provides an accounting model for the accounting for Web site development costs, which considers the stages of Web site development and the types of costs incurred in each stage. You should read the full text of the EITF Issue for a complete understanding of how to account for Web site development costs. Some main points of EITF Issue 00-2 are—

- Hardware costs are outside the scope of EITF Issue 00-2 and should be accounted for normally in accordance with generally accepted accounting principles (GAAP).
- Costs relating to software used to operate a Web site should be accounted for under SOP 98-1, *Accounting for the Costs of Computer Software Developed or Obtained for Internal Use*, unless a plan exists or is being developed to market the software externally, in which case the costs relating to the software should be accounted for pursuant to FASB Statement No. 86, *Accounting for the Costs of Computer Software to Be Sold, Leased, or Otherwise Marketed.*
- Fees paid to a firm to host a Web site generally would be expensed over the period of benefit.
- Planning stage costs should be expensed as incurred.

- Costs of developing initial graphics should be accounted for pursuant to SOP 98-1 for internal-use software.
- Accounting for Web site content (information included in the Web site) will be addressed in a future EITF issue.
- Costs incurred during the operating stage, including training, administration, and maintenance, should be expensed as incurred.
- Costs incurred in the operating stage that involve upgrades and enhancements that add functionality should be expensed or capitalized based on the general model of SOP 98-1.

> **Help Desk**—The EITF was established by the FASB in July 1984 to assist in improving financial reporting through the timely identification, discussion, and resolution of financial issues within the framework of existing authoritative literature. The application of EITF consensuses (category c of the GAAP hierarchy) effective after March 15, 1992, is mandatory under SAS No. 69, *The Meaning of* Present Fairly in Conformity With Generally Accepted Accounting Principles *in the Independent Auditor's Report* (AICPA, *Professional Standards*, vol. 1, AU sec. 411). Any EITF consensus issued before March 16, 1992, becomes effective in the hierarchy for initial application of an accounting principle after March 15, 1993. The EITF meets approximately every eight weeks. All meetings are announced by the FASB in its *Action Alert*, together with a listing of the topics on the meeting agenda.

Institutions may spend substantial amounts of money soliciting customers to gain market share for their e-commerce activities. These costs may take on different forms, such as direct response advertising, paid-for Web links, mailings, and direct e-mail. Advertising is one kind of customer acquisition activity. SOP 93-7, *Reporting on Advertising Costs*, provides accounting guidance for advertising costs, including direct-response advertising. Other kinds of customer acquisition activities are outside the scope of SOP 93-7. Currently, diversity in practice exists in accounting for all other customer acquisition costs. The AICPA Accounting

Standards Executive Committee (AcSEC) has a project on its agenda to address the accounting for such costs. The appendix to SOP 93-7 provides a list of accounting pronouncements that AcSEC considered in determining how to account for advertising costs. That same list of accounting literature may help you to determine how to account for customer acquisition costs.

Audit and Accounting Issues and Developments

What are some of the significant accounting and auditing considerations for dealerships?

Although mergers and acquisitions have slowed, many independent dealerships continue to have audits performed because they may be considered take-over candidates and they want to "cash in" on the consolidation trend. Because of the continuing trend to have an audit, we will revisit the topic of the need for an audit in this year's Alert.

The value of these dealerships is usually estimated based on multiples of earnings on the dealerships (resulting in goodwill on earnings and earnings capacity). Many dealers believe that having audited financial statements will give potential purchasers greater confidence in the reported results, resulting in payments of higher multiples of earnings. Because of this, more dealerships are having audits done. In addition, dealerships may feel more pressure than usual to report strong results. The potential that the financial statements might be used in acquisition negotiations increases the risk to the auditor.

Analytical procedures include the analysis of significant ratios, trends, or modeling, including the resulting investigation of fluctuations and relationships that deviate from patterns expected by the auditor. SAS No. 56, *Analytical Procedures*, provides auditors with guidance on the required use of analytical procedures in the planning and overall review stages of all audits. Especially in this period of increased consolidation in the industry, auditors should ensure that analytical procedures performed during these stages are adequately designed to detect evidence that the results being reported have not been artificially inflated. In addition, auditors may use analytical procedures as substantive procedures during fieldwork. It is important to have audit staff with sufficient industry and auditing expertise perform such analysis, particularly if the results of such analysis may be used to justify a reduction of the use of other substantive auditing procedures. In performing analytical procedures, the auditor compares amounts or ratios with expected results developed from such sources as the following:

- Prior-period financial information
- Budgets or forecasts
- Relationship among elements of financial information in the same period
- Relationship among financial and nonfinancial data
- Industry data compiled by services (for example, Ward's Dealer Business Database 2000)
- Manufacturer "composites" by brand of vehicle[18]
- A group of twenty (A group of twenty generally comprises, at the most, twenty dealers that sell the same type vehicle [that is, the same franchise] and are approximately the same size but are not from the same market area. Because they are not in competition with one another, financial information from each dealership can be freely exchanged. This information is compiled in a monthly composite so each dealer can compare its performance with the other dealerships' performances and against the group average.)

  Help Desk—"Twenty groups" are sponsored and monitored by a few organizations. Two such organizations are NADA 20 Group and NCM Associates. Other sources of benchmarking information are industry publications and the Internet. In addition, the AICPA APR *Analytical Procedures* provides guidance on the effective use of analytical

18. Many manufacturers maintain "composites" by brand of vehicle. Composites are ratios and statistics that dissect the performance of dealers. Auditors may want to ask their clients to obtain the manufacturer composites so that a comparison can be made with the average.

procedures, with an emphasis on analytical procedures as substantive tests. This APR can be ordered through the AICPA order department (member satisfaction) at (888) 777-7077, Product No. 021069kk.

Auditor Independence

Why should you be concerned with independence? Are there any new Independence Standards Board (ISB) standards?

Independence is a unique and important quality of CPAs that sets us apart from other professions. SAS No. 1, *Codification of Auditing Standards and Procedures* (AICPA, *Professional Standards*, vol. 1, AU sec. 150.02, "Generally Accepted Auditing Standards") of generally accepted auditing standards (GAAS) requires that, in all matters relating to the audit engagement, an independence in mental attitude is to be maintained by the auditor. SAS No. 1 (AICPA, *Professional Standards*, vol. 1, AU sec. 220.03, "Independence") provides that "to be independent, the auditor must *be* intellectually honest; to be *recognized* as independent, he must be free from any obligation to or interest in the client, its management, or its owners." Although this sounds fairly straightforward, making a determination as to whether one is actually independent or not can get complicated.

In assessing independence, it is useful to first address two issues. The first is to assess whether independence is required for the professional service you are providing. Keep in mind that independence is a requirement not just for traditional audits, but for a number of different professional services covered by auditing and attestation standards. The second issue is to determine where the applicable independence standards can be found. Independence standards are promulgated by different standard-setting bodies.

If the engagement under consideration requires independence, and the entity being audited is privately held, the applicable independence standards can be found in the AICPA's Code of Professional Conduct rule 101, Independence (AICPA, *Professional Standards*, vol. 2, ET sec. 101). Interpretations and Rulings under rule 101 address a number of issues affecting independence, including direct or material indirect financial interests in an enterprise; joint, closely held business investments with an enterprise; loans to or from an enterprise; and many others.

Among some of the more common independence issues facing small practitioners and privately held entities are the following:

- *Providing a professional service requiring independence to a client for whom accounting services are also performed*. This may result in a situation that impairs independence. Consider the guidance set forth in Ethics Interpretation No. 101-3, "Performance of Other Services," of ET section 101, *Independence* (AICPA, *Professional Standards*, vol. 2, ET sec. 101.05).

- *Providing a professional service requiring independence to a client that has not paid fees for previously rendered services*. Past-due fees may impair independence. This issue is addressed by Ethics Ruling No. 52, "Unpaid Fees," of ET section 191, *Ethics Rulings on Independence, Integrity, and Objectivity* (AICPA, *Professional Standards*, vol. 2, ET sec. 191.103–.104).

- *Providing a professional service requiring independence to a client for whom services such as internal audit activities are provided*. See Ethics Interpretation 101-13, "Extended Audit Services," of ET section 101, *Independence* (AICPA, *Professional Standards*, vol. 2, ET sec. 101.15) to assess the impact on independence.

- *Providing a professional service requiring independence to a client when certain family relationships exist*. Refer to Ethics Interpretation No. 101-9, "The Meaning of Certain Independence Terminology and the Effect of Family Relationships on Independence," of ET section 101, *Independence* (AICPA, *Professional Standards*, vol. 2, ET sec. 101.11).

  Help Desk—Assessing independence can be a complex and time-consuming undertaking. The AICPA can offer assistance. Call (888) 777-7077 (prompt 3, then prompt 2) to speak to a member of our Professional Ethics team with your questions relating to AICPA independence standards. You may also submit your question in an e-mail to ethics@aicpa.org. Also see the *AICPA Plain English Guide to Independence* available only on the AICPA's Web site at www.aicpa.org/members/div/ethics/index.htm.

If, however, the entity being audited is a Securities and Exchange Commission (SEC) registrant and the engagement under consideration requires independence, things get a bit more complicated. To assess the independence of auditors of publicly held entities, AICPA standards must be considered, along with standards set by the SEC and the ISB.

SEC auditor independence rules are set forth in rule 2-01 of SEC regulation SX, along with its interpretations, guidelines, and examples as collected in section 600 of the Codification of Financial Reporting Policies titled *Matters Relating to Independent Accountants*. The independence standards of the SEC and ISB[19] must be followed if, on a particular issue, they are either more restrictive[20] than those of the AICPA or they address an issue on which the AICPA Code of Professional Conduct is silent. If, on the other hand, the independence standards of the SEC and ISB are silent on a particular issue or less restrictive (generally speaking, this is unlikely), the AICPA independence standards should be followed.

Help Desk—The ISB staff answers auditor independence inquiries (regarding auditors of public companies only) from practitioners, registrants, and other interested parties on both a formal and informal basis. Formal inquiries, which must be submitted in writing, result in written staff interpretations that can be relied upon by the requesting parties as being authoritative in dealing with the SEC. If and when the staff interpretations are ratified by the ISB Board, staff interpretations represent authoritative guidance for all registrants and their auditors. For further information, contact the ISB at (212) 596-6133 or visit its Web site at www.cpaindependence.org.

19. The SEC recognizes the ISB as a standard-setting body that will establish and maintain a body of independence standards applicable to auditors of all SEC registrants, as discussed in Authorizing SEC Release (FRR-50).

20. For example, AICPA rules provide that independence is not necessarily impaired if bookkeeping services are provided to a client. SEC rules view this situation as an impairment of independence.

The ISB

The ISB was established in May 1997 as part of an agreement between the AICPA and the SEC. Its charge is to establish, maintain, and improve independence standards for external auditors of SEC registrants. Although the SEC retains its statutory authority to define independence, it recognizes the responsibility of the ISB in establishing independence standards and interpretations for auditors of public entities. The SEC also considers principles, standards, interpretations, and practices issued by the ISB as having substantial authoritative support. Note that the pronouncements of the ISB apply to auditors of publicly held entities only. The functioning of the ISB does not affect the authority of state licensing or disciplinary authorities regarding auditor independence. Also, it does not affect the AICPA's rules on independence as they relate to auditors of nonpublic entities.

Since our last Alert, the ISB has issued the following independence standards:

1. ISB Standard No. 2, *Certain Independence Implications of Audits of Mutual Funds and Related Entities*
2. ISB Standard No. 3, *Employment with Audit Clients*

The following interpretations were issued by the ISB during 2000:

- ISB Interpretation 00-1, *ISB No. 1 and Secondary Auditors*
- ISB Interpretation 00-2, *An Amendment of Interpretation 00-1*

> **Help Desk**—The full text of these standards and interpretations, along with information about other ISB publications and exposure drafts, are posted on the ISB's Web site at www.cpaindependence.org/pubs_db.php3.

SEC Proposals on the Modernization of Auditor Independence

Recently, the SEC issued a proposal on auditor independence. If you are an auditor of an entity that is subject to SEC regulations, you will need to gain an understanding of the changes being proposed. *Do not forget* to follow SEC action on this proposal to see how the final regulations turn out. See the Audit Risk Alert, *SEC*

Industry Developments 2000/01 (Product No. 022260kk), for a summary of the proposals.

> **Help Desk**—The full text of the proposed rule changes can be obtained from the SEC's Web site at www.sec.gov/news/audind2.htm.

The SEC has engaged in other important activities this year, such as the issuance of new staff accounting bulletins on restructuring and impairment charges, and revenue recognition in financial statements. For complete discussions of these and other SEC-related matters, please refer to our newly introduced SEC Alert. Developed in conjunction with SEC staff, the SEC Alert provides valuable insights into staff perspectives on important auditing and accounting matters. See "Resource Central" later in this Alert for further information.

Executive Summary—Auditor Independence

- Independence—though in principle it may sound simple, determining whether you are independent can get tricky.
- In assessing independence you must determine if the engagement you are performing is one that requires independence. If so, you must then know what standards apply.
- For the audits of privately held entities, refer to the AICPA's independence standards. Also keep in mind that state societies, state boards, and regulatory agencies may also have independence standards that you must consider.
- For the audits of publicly held entities, SEC, ISB, and AICPA standards must be considered.
- Help is available. Contact the AICPA or the ISB for answers to your independence questions.

Inventory and Notes Payable Under Floor Plan Arrangements

Vehicle inventory and floor plan financing are usually the most significant asset and liability, respectively, on the balance sheet of an auto dealer. Auditors should be alert to the potential for a high level of audit risk associated with these areas.

Inventory

Audit risk relating to vehicle inventory usually involves issues such as the following:

Proper cutoff of sales and purchases transactions. Transactions occurring near year-end should be examined to ensure that they are recorded in the period in which the related revenue has been earned or the expense incurred. Procedures that may be performed by the auditor to assess the proper cutoff of sales and purchase transactions (see the completeness and occurrence assertions in SAS No. 31, AU sec. 326.03) include the observation of physical inventory counts, analytical procedures comparing the relationship of inventory balances to recent purchasing and sales activities, and testing the client's cutoff procedures for shipping, receiving, sales, and purchases.

Inventory valuation. All inventory should be measured at the lower of cost or market. Any reduction to market becomes the subsequent cost basis pursuant to FASB Accounting Research Bulletin (ARB) No. 43, chapter 4, "Inventory Pricing."

New vehicles are generally valued at cost to the dealership. The items included in cost vary by manufacturer; for example, some manufacturers establish the cost of new vehicle inventory as factory invoice amount plus internal selling price of dealer add-ons, less any holdbacks, unrelated items such as supplemental advertising, and factory price reductions. Other manufacturers simply price the new vehicle at factory base price, plus factory-installed options, freight, and dealer association advertising charges. Auditors can test new vehicle inventory valuations by examining manufacturers' invoices.

Used vehicle inventory is usually valued at the lower of cost or estimated wholesale value. Cost represents the actual cost of the vehicle when it is purchased. When the vehicle is acquired in a trade-in along with a new or used vehicle sale, the appraised value is used as cost. Auditors usually can test used vehicle inventory valuations by referencing to published valuation guidelines, such as Black Book or NADA publications. Auditors may also assess the value of used vehicles by running a "subsequent sales test" to see if the used vehicles are truly reported at the lower of cost or market. Because used vehicles are usually sold quickly, a meaningful test could be run within thirty days after year end.

Dealerships typically value their parts and accessories inventories at replacement cost. Because this method is a departure from GAAP, auditors of dealerships should consider the effect of this misstatement on the financial statements and on their report. SAS No. 58, *Reports on Audited Financial Statements* (AICPA, *Professional Standards*, vol. 1, AU secs. 508.35–508.60), describes the circumstances that may require a qualified or adverse opinion when the financial statements contain a departure from GAAP. A qualified opinion is expressed when the auditor believes, on the basis of his or her audit, that the financial statements contain a departure from GAAP, the effect of which is material, and he or she has concluded not to express an adverse opinion. An auditor should express an adverse opinion when, in the auditor's judgment, the financial statements taken as a whole are not presented fairly in conformity with GAAP.

Dealerships often use the last-in, first-out (LIFO) inventory method to determine ending inventory and cost of goods sold. By using LIFO, dealerships can significantly reduce their taxable income.

Inventory ownership. Failure to determine ownership can result in the overstatement of inventory through, for example, improper sales or purchase cutoff or incorrect assessment of when a title passes in sales or purchase transactions (free-on-board (FOB) shipping point or FOB destination). Procedures that may be performed by the auditor to assess whether the inventory balance shown on the client's balance sheet is actually owned by the client (see the rights and obligations assertion in SAS No. 31, AU sec. 326.03). They include—

- Observing physical inventory counts.
- Obtaining confirmation of inventories at locations outside the entity.

- Testing cutoff procedures relating to purchases and sales, as well as examining paid vendors' invoices, shipping terms, consignment agreements, and bill and hold arrangements.

Physical existence of vehicle inventory. A key audit objective is to establish the existence of inventory. Procedures that may be performed by the auditor to make this assessment (see the existence assertion in SAS No. 31, AU sec. 326.03) may include observation of the client's physical inventory count and obtaining confirmation of inventories at locations outside the entity, along with the testing of inventory transactions between a preliminary physical inventory date and the balance sheet date. Auditors also may consider communicating with the various floor plan institutions with which the dealership operates. Usually, such institutions will perform periodic, surprise inventory checks throughout the year. Auditors may want to inquire if there were any problems found with those inventory checks.

Notes Payable Under Floor Plan Arrangements

A floor plan line of credit is an arrangement with a lender to finance purchases of inventory. Each floor plan note is secured by an individual vehicle. When the vehicle is sold, the related floor plan liability is usually due within three days. With the rise in interest rates, this account takes on greater importance. In fact, the average dealer's floor plan interest (for the new and used car departments) for the first half of 2000 increased 52 percent over the first half of 1999.[21] Auditors should consider confirming such notes with the lender. SAS No. 67, *The Confirmation Process* (AICPA, *Professional Standards*, vol. 1, AU sec. 330), provides guidance on the confirmation process, including evaluating the results and performing alternative procedures when responses to confirmation requests are not received. Auditors should pay particular attention to issues dealing with collateralization and valuation of the underlying inventory and with timely payment of the notes. In addition, it is important for auditors to consider internal controls over matching specific inventory owned to the specific vehicles collateralizing the floor plan

21. *Automotive Executive Magazine*, October 2000: 25.

financing to assure the dealer is not "out-of-trust." Typically an out-of-trust situation would make the floor plan note callable at the option of the lender. In out-of-trust situations, auditors should consider verifying the date of the subsequent payment of the note.

Revenue Recognition Related to the Sale of Extended Warranties

Revenue recognition continues to pose significant audit risk to auditors. One area of concern to dealerships is revenue related to the sale of extended warranty contracts. New vehicles are typically sold with a manufacturer warranty for certain mechanical repairs. Dealerships may sell extended warranty contracts that typically cover the cost of certain mechanical repairs to used vehicles or to new vehicles once the factory warranty runs out. Extended warranty contracts are found in two forms: those in which the warranty company is the primary obligor (the dealer acts as a broker) and those in which the dealership is the primary obligor.

When the contract is underwritten by the manufacturer or an unrelated insurer, the dealership has no ongoing responsibility for the contract. In other words, the dealership has no obligation to the customer to perform any warranty repairs.[22] If the dealer is acting as an agent, it should consider whether the revenue should be recorded gross or net as set forth in EITF Issue No. 99-19, *Reporting Revenue Gross as a Principal versus Net as an Agent*. In this situation, the recording of the commissions at the point of sale of the policy is appropriate because the dealership has completed the revenue earning process.

In situations where the dealership is the primary obligor, the dealership may be required to bear the cost of the warranty repairs in certain situations, for example, if the warranty company ceases to exist. Accounting for these types of contracts is covered by FASB Technical Bulletin (TB) No. 90-1, *Accounting for Separately Priced Extended Warranty and Product Maintenance Contracts*. TB 90-1 states in part that:

22. If the dealer has not been legally released as the primary obligor under the contract, even though it may be underwritten by the manufacturer or an unrelated insurer, then TB 90-1 would apply.

> Revenue from separately priced extended warranty and product maintenance contracts should be deferred and recognized in income on a straight-line basis over the contract period except in those circumstances in which sufficient historical evidence indicates that the costs of performing services under the contract are incurred on other than a straight-line basis. In those circumstances, revenue should be recognized over the contract period in proportion to the costs expected to be incurred in performing services under the contract.

If the dealership expects the costs of providing services (and any unamortized costs) under a group of contracts to exceed the unearned revenue, a loss should be recognized. The loss is to be recognized by charging an expense account. Any unamortized costs should be credited and, if the loss exceeds the unamortized costs, a liability should be established for the excess.

Auditors should be alert to situations where a dealership records sales of both forms of extended warranty policies in the same manner. That is, they recognize revenue upon receipt of the premium. As mentioned earlier, when the dealership is the obligor, this accounting treatment would not be in accordance with GAAP and auditors should consider the effect of this departure from GAAP on their report. SAS No. 89 *Audit Adjustments*, (AICPA, *Professional Standards*, vol. 1, AU secs. 310, 333, and 380), amends SAS No. 83, *Establishing an Understanding With the Client* (AICPA, *Professional Standards*, vol. 1, AU sec. 310); SAS No. 85, *Management Representations* (AICPA, *Professional Standards*, vol. 1, AU sec. 333); and SAS No. 61, *Communication With Audit Committees* (AICPA, *Professional Standards*, vol. 1, AU sec. 380). Keep in mind that SAS No. 89 establishes audit requirements designed to encourage client management to record financial statement adjustments aggregated by the auditor. See the summary of SAS No. 89 in the "New Auditing Pronouncements" section of this Audit Risk Alert. Auditors also should be aware that the income tax treatment for extended warranty contracts when the dealership is the obligor is different from GAAP and therefore could result in permanent and temporary taxable or deductible differences.

Help Desk—Recently, the SEC staff has issued Staff Accounting Bulletin (SAB) No. 101, *Revenue Recognition in Financial Statements*. This SAB summarizes certain of the staff's views in applying GAAP to revenue recognition in financial statements. The staff is providing this guidance due, in part, to the large number of revenue recognition[23] issues registrants encounter. The complete text of the SAB can be downloaded from the SEC's Web site at www.sec.gov/rules/acctindx.htm.

Other Issues

Customer Incentives

Many dealerships are now offering special incentives to customers, such as free oil changes for a certain period of time. Auditors should inquire if their client has offered any such incentives. Recently the EITF has been discussing issues relating to certain sales incentives. The following EITF issues relate to the accounting for sales incentives and should be considered:

- EITF Issue No. 00-14, *Accounting for Certain Sales Incentives* (Consensuses were reached May 17–19, 2000, with revisions made to the EITF Abstracts at the September 20–21, 2000 meeting.)
- EITF Issue No. 00-21, *Accounting for Multiple-Element Revenue Arrangements* (Originally discussed at the July 19–20, 2000 meeting, further discussion is planned at future meetings.)
- EITF Issue No. 00-22, *Accounting for "Points" and Certain Other Time-Based or Volume-Based Sales Incentive Offers, and Offers for Free Products or Services to Be Delivered in the Future* (Originally discussed at the September 20–21, 2000 meeting, further discussion is planned at future meetings.)

For more information about the EITF, see the section "EITF Consensus Positions" in this Audit Risk Alert. In addition, consider the

23. The AICPA is currently developing a new Audit Guide that addresses industry-specific revenue recognition issues. Look for announcements in the *CPA Letter* and the *Journal of Accountancy* for the Guide's availability.

guidance in SAS No. 89, *Audit Adjustments*, when evaluating whether such sales incentives have been properly accounted for. SAS No. 89 establishes audit requirements designed to encourage client management to record financial statement adjustments aggregated by the auditor. (See the summary of SAS No. 89 in the "New Auditing Pronouncements" section of this Audit Risk Alert.)

Tax Issues

What are some areas of continued concern to the IRS?

Although there has not been a lot of activity over the past year relating to tax issues for dealerships, there are some areas of continued concern to the IRS that are worth revisiting. These include tax regulations relating to parts inventory and LIFO conformity rules. In auditing the financial statements of auto dealerships, in particular, when evaluating management's accounting for income taxes in accordance with FASB Statement No. 109, *Accounting for Income Taxes*, as amended, auditors should be familiar with federal, state, and local tax rules.

Parts Inventory

Recently, the U.S. Tax Court ruled that the use of replacement cost to value parts is contrary to LIFO regulations, and the IRS added the entire parts LIFO reserve back into the dealer's income. The Tax Court ruled that parts should be valued at actual cost rather than replacement cost.[24] In response to this, the NADA has proposed four alternatives to the IRS for ways dealers using LIFO should value parts inventory. The NADA proposes that dealers may—

- Value inventory based on actual cost of most recent purchases (the method most dealers currently use).
- Adjust year-end value based on number of turns for the year.

24. *Mountain State Ford Truck Sales, Inc. vs. Comm*. (Docket No. 16350-95) can be obtained from the Tax Court Web site, www.taxcourt.gov.

- Use automakers' midyear prices to price current inventory.
- Price year-end inventory against pricing at the beginning of the year.

This case is currently on appeal.

> **Help Desk**—Some dealerships using LIFO may value their parts and accessories inventories at replacement cost. Because this method is a departure from GAAP, auditors of dealerships should consider the effect of this misstatement on the financial statements and on their report. SAS No. 58 (AU sec. 508.35–508.60) describes the circumstances that may require a qualified or adverse opinion when the financial statements contain a departure from GAAP. A qualified opinion is expressed when the auditor believes, on the basis of his or her audit, that the financial statements contain a departure from GAAP, the effect of which is material and he or she has concluded not to express an adverse opinion. An auditor should express an adverse opinion when, in the auditor's judgment, the financial statements taken as a whole are not presented fairly in conformity with GAAP.

LIFO Conformity Rules

LIFO continues to be a focus of concern for the IRS. Franchised automobile dealers are normally required to issue monthly income statements to their franchisor, who is also typically a creditor of the dealership. These monthly statements are often prepared in a format required by the franchisor or on a preprinted form supplied by the franchisor. The twelfth-month statement is normally issued within a few days after the end of the year and presents the dealership's operating results for both the month and the calendar year. It is subsequently amended by another income statement commonly known as the thirteenth-month statement.

For several years, there was uncertainty about whether certain monthly income statements issued to the franchisor or creditor violated the LIFO conformity requirement of Internal Revenue Code (IRC) section 472(c) or (e)(2). In 1997, the IRS issued guidance to assist auto dealers in determining whether they had violated the LIFO conformity requirement (Revenue Ruling 97-42). In addition, the IRS also issued guidance to forgive certain LIFO conformity violations by auto dealers that occurred on or before October 14, 1997 (Revenue Procedure 97-44).

Revenue Ruling 97-42 provides that an auto dealer has violated the LIFO conformity requirement by providing the credit subsidiary of its franchisor with a twelfth-month income statement (in the format required by the franchisor or on preprinted forms supplied by the franchisor) for the tax year, if that statement fails to reflect the LIFO inventory method in the computation of net income. The ruling provides that an auto dealer has not violated the LIFO conformity requirement if the twelfth-month income statement issued to the credit subsidiary of its franchisor uses the LIFO inventory method to determine net income for both the twelfth-month and for the entire year (even if the LIFO adjustment is only a reasonable estimate.) The LIFO adjustment can be made either against cost of goods sold (so that it is reflected in gross profit) or as an adjustment below the line (so that it is reflected in net income). The IRS may feel that the use of a constant LIFO reserve throughout the year is not a reasonable estimate when the dealer is not on a calendar-year basis.

Auto dealers could have received relief under Revenue Procedure 97-44 for prior LIFO conformity violations; however, the relief did not apply to all prior conformity violations. The settlement amount was due by May 31, 1998, as an initial installment of one third of the total, followed by two other equal payments on January 31, 1999, and January 31, 2000. Failure to make any of these installment payments in a timely manner would void the relief protection.

An auto dealer not making a settlement payment should take steps to fully document the fact that it is not required to make such a payment. Copies of all available monthly and annual income statements issued during the look-back period (of six years) should be retained, as well as any other evidence to document when and to whom statements were issued.

In the future, auto dealers should make certain that, for all income statements issued currently and in the future to shareholders and creditors, they comply with the LIFO conformity rules of IRC section 472, as well as Revenue Ruling 97-42.

Auditors should be aware of the issue of conformity violations thus far discussed. If an auto dealership has violations and has failed to use the relief that expired on May 31, 1998, the IRS can terminate the dealership's LIFO election and the income tax owed would become due immediately, plus interest and penalties that, in most cases, will be substantial.

IRS Rulings and Procedures that apply include—

- IRS Revenue Procedure 97-36, which supersedes IRS Revenue Procedure 92-79 and is effective August 18, 1997. Revenue Procedure 92-79 specified the LIFO inventory valuation approach and standardized the LIFO calculation for new vehicles. The alternative method discussed in Revenue Procedure 97-36 is the same as the method in Revenue Procedure 92-79 and therefore may not significantly change what dealerships do.
- IRS Revenue Ruling 97-42, which provides guidance to assist auto dealers in determining whether they have violated the LIFO conformity requirements.
- IRS Revenue Procedure 97-44, which gives special relief for certain LIFO conformity violations as long as the action was taken by May 31, 1998. The NADA also issued guidance in this area in its publication *A Guide to the LIFO Conformity Settlement*.

Other Areas of Continued Concern

The IRS continues to focus on certain areas that we will revisit in this year's Alert.

The Use of Demonstrators

The IRS aggressively reviews dealership's policies and practices regarding demonstrator vehicles. Demonstrator inventory comprises the value of new vehicles placed in demonstrator service.

Generally these autos are taken out of the new inventory accounts. Any labor and material costs for dealer-installed equipment and accessories are added to the inventory value; the cost of any such equipment or accessories removed from the vehicle is subtracted from inventory. Many dealerships limit the number of miles that demonstrators may be driven. Demonstrators are generally not written down for wear and tear or depreciation because, even after use, their market values generally exceed inventory cost. If cost exceeds value, however, a write-down may be necessary. When a demonstrator is sold, it is transferred back to new vehicle inventory because the sale is reported as a new vehicle sale.

If the IRS determines that a dealership violated the special rules that govern qualified automobile demonstration use, the value of the use of employer-provided vehicles is a fringe benefit that must be included in the employee's gross income, and the dealer will need to pay the related employment taxes. IRS Private Letter Ruling 9801002 discusses situations in which the IRS found a dealership to be in violation of the special rules for "certain fringe benefits." The private letter ruling says that qualified automobile demonstration use should be treated as a working condition fringe. (Section 132(a)(3) specifically provides that qualified automobile demonstration use should be treated as a working condition fringe.) *Qualified automobile demonstration use* is defined as any use of an automobile by a full-time automobile salesman in the sales area in which the automobile dealer's sales office is located if—

1. Such use is provided primarily to facilitate the salesman's performance of services for the employer.
2. There are substantial restrictions on the personal use of the automobile by the salesman.

The substantial restrictions on the personal use of the automobile by the salesman exist when all of the following conditions are met:

1. Use by individuals other than the full-time automobile salesman is prohibited.
2. Use for personal vacation trips is prohibited.

3. The storage of personal possessions in the automobile is prohibited.
4. The total use of the automobile, by mileage, by the salesman outside the salesman's normal working hours is limited.

The IRS will typically examine the records of demonstrator vehicles to substantiate that only qualified personnel have been assigned demonstrators and that personal use is accounted for properly. Lists of personnel-assigned demonstrator vehicles may be checked against payroll records to detect family members and others who do not qualify for demonstrator vehicles. Individuals not qualifying for demonstrator vehicles would have to report additional income attributable to their personal use of a company vehicle. Depreciation expense accounts are reconciled to verify that depreciation is not taken on demonstrator vehicles.

You may want to familiarize yourself with Private Letter Ruling 9801002 to see where the IRS found the dealership to be in violation and compare that with the practices of your clients.

Service Technician Tool Program

In July 2000 the IRS issued a "Coordinated Issue Paper,"[25] *Service Technician Tool Reimbursement* (the Issue Paper), which reflects the IRS's current thinking on service technician tool reimbursements. Service technicians, although employees of the dealership, are typically required to provide and maintain their own tools. Many dealers will pay service technicians hourly and will divide the hourly amount paid into a wage portion and a portion to reimburse the service technicians for their tools. This tool reimbursement portion typically has no income or employment taxes withheld on it. In the Issue Paper (UIL 62.15-00), the IRS has said that only tool reimbursements under an "accountable plan" can be excluded from wages and it sets forth what constitutes a qualified plan; however, generally, such tool reimbursements paid

25. The Coordinated Issue Papers reflect the IRS's current thinking on a wide range of industries and issues (although they are not official pronouncements on the issues). These papers are issued by the Assistant Commissioner (Examination) and are reviewed by the Office of Chief Counsel. To view these issue papers visit the IRS Web site at www.irs.ustreas.gov/bus_pro/coord.html.

to service technicians will not meet the accountable plan requirements and therefore such amounts are subject to withholding and payment of federal employment taxes. See the IRS Issue Paper for a complete discussion of this topic.

Credit Life Insurance Companies

Another emerging trend is the sale of credit life insurance with the sale of a vehicle. For an additional premium, customers can purchase insurance that will pay the balance on their car loans if something happens to them. These insurance companies (whether offshore or domestic) may be related to the dealership. If your client has any affiliated companies that deals in credit life or other insurance, you should consider examining the relationship and determine the tax liability associated with it.

Executive Summary—Tax Issues

- A Tax Court ruling that parts should be valued at actual cost rather than at replacement cost raises questions about how dealers should be valuing their parts inventory. This case is currently on appeal.
- The IRS continues to focus on LIFO conformity rules, IRS cash reporting, the use of demonstrators, service technician tool programs, and credit life insurance companies.

New Auditing and Attestation Pronouncements

What new auditing and attestation pronouncements have been issued this year?

Auditing Standards

In this section we present either brief summaries or a listing of recently issued auditing pronouncements. The summaries are for informational purposes only and should not be relied on as a substitute for a complete reading of the applicable standard. For information on auditing pronouncements issued subsequent to the writing of this Alert, please refer to the AIPCA Web site at www.aicpa.org/members/div/auditstd/technic.htm. You may also look for announcements of newly issued standards in the *CPA Letter* and *Journal of Accountancy*.

SAS No. 88, *Service Organizations and Reporting on Consistency*

In December 1999, the AICPA Auditing Standards Board (ASB) issued SAS No. 88, *Service Organizations and Reporting on Consistency* (AICPA, *Professional Standards*, vol. 1, AU sec. 324 and 420), which amends two auditing standards. Part 1, "Service Organizations," amends SAS No. 70, *Reports on the Processing of Transactions by Service Organizations* (AICPA, *Professional Standards*, vol. 1, AU sec. 324.03 and 324.06–.10), to—

1. Clarify the applicability of SAS No. 70 by stating that the SAS is applicable if an entity obtains services from another organization that are part of the entity's information system. It also provides guidance on the types of services that would be considered part of an entity's information system.
2. Revise and clarify the factors a user auditor should consider in determining the significance of a service organization's controls to a user organization's controls.
3. Clarify the guidance on determining whether information about a service organization's controls is necessary to plan the audit.
4. Clarify that information about a service organization's controls may be obtained from a variety of sources.
5. Change the title of SAS No. 70 from *Reports on the Processing of Transactions by Service Organizations* to *Service Organizations*.

Part 2, "Reporting on Consistency," amends SAS No. 1, *Codification of Auditing Standards and Procedures* (AICPA, *Professional Standards*, vol. 1, AU sec. 420, "Consistency of Application of Generally Accepted Accounting Principles"), to—

1. Conform the list of changes that constitute a change in the reporting entity (AU sec. 420.07) to the guidance in paragraph 12 of Accounting Principles Board (APB) Opinion No. 20, *Accounting Changes*.

2. Clarify that the auditor need not add a consistency explanatory paragraph to the auditor's report when a change in the reporting entity results from a transaction or event.

3. Eliminate the requirement for a consistency explanatory paragraph in the auditor's report if a pooling of interests is not accounted for retroactively in comparative financial statements.

4. Eliminate the requirement to qualify the auditor's report and consider adding a consistency explanatory paragraph to the report if single-year financial statements that report a pooling of interests do not disclose combined information for the prior year.

All of the amendments contained in SAS No. 88 were effective upon issuance.

SAS No. 89, *Audit Adjustments*

In December 1999, the ASB issued SAS No. 89, *Audit Adjustments* (AICPA, *Professional Standards*, vol. 1, AU secs. 310, 333, and 380), which amends three SASs to establish audit requirements designed to encourage client management to record financial statement adjustments aggregated by the auditor. It also clarifies management's responsibility for the disposition of financial statement misstatements brought to its attention. SAS No. 89 amends SAS No. 83, *Establishing an Understanding With the Client* (AICPA, *Professional Standards*, vol. 1, AU sec. 310); SAS No. 85, *Management Representations* (AICPA, *Professional Standards*, vol. 1, AU sec. 333); and SAS No. 61, *Communication With Audit Committees* (AICPA, *Professional Standards*, vol. 1, AU sec. 380), as follows:

1. SAS No. 83 is amended to include in the understanding with the client management's responsibility for determining the appropriate disposition of financial statement misstatements aggregated by the auditor. Specifically, SAS No. 89 adds the following to the list of matters that generally are included in the understanding with the client:

Management is responsible for adjusting the financial statements to correct material misstatements and for affirming to the auditor in the representation letter that the effects of any uncorrected misstatements aggregated by the auditor during the current engagement and pertaining to the latest period presented are immaterial, both individually and in the aggregate, to the financial statements taken as a whole.

2. SAS No. 85 is amended to require that the management representation letter include an acknowledgment by management that it has considered the financial statement misstatements aggregated by the auditor during the current engagement and pertaining to the latest period presented and has concluded that any uncorrected misstatements are immaterial, both individually and in the aggregate, to the financial statements taken as a whole. It also requires that a summary of the uncorrected misstatements be included in or attached to the representation letter.
3. SAS No. 61 is amended to require the auditor to inform the audit committee about uncorrected misstatements aggregated by the auditor during the current engagement and pertaining to the latest period presented, whose effects management believes are immaterial, both individually and in the aggregate, to the financial statements taken as a whole.

These amendments are effective for audits of financial statements for periods beginning on or after December 15, 1999, with early adoption permitted.

SAS No. 90, *Audit Committee Communications*

SAS No. 90, *Audit Committee Communications* (AICPA, *Professional Standards*, vol. 1, AU secs. 380 and 722), issued by the ASB in December 1999, amends SAS No. 61 and SAS No. 71, *Interim Financial Information* (AICPA, *Professional Standards*, vol. 1, AU sec. 722). SAS No. 90 was issued in response to recommendation numbers 8 and 10 of the report of the Blue Ribbon Committee on Improving the Effectiveness of Corporate Audit Committees, which suggest changes to GAAS.

Among other things, the amendment to SAS No. 61 requires an auditor to discuss with the audit committees of SEC clients certain information relating to the auditor's judgments about the quality, not just the acceptability, of the company's accounting principles and underlying estimates in its financial statements. It also encourages a three-way discussion among the auditor, management, and the audit committee. This amendment is effective for audits of financial statements for periods ending on or after December 15, 2000, with earlier application permitted.

The amendment to SAS No. 71 clarifies that the accountant should communicate to the audit committee or be satisfied, through discussions with the audit committee, that matters described in SAS No. 61 have been communicated to the audit committee by management when they have been identified in the conduct of interim financial reporting. This amendment also requires the accountant of an SEC client to attempt to discuss with the audit committee the matters described in SAS No. 61 before the filing of the Form 10-Q. This amendment is effective for reviews of interim financial information for interim periods ending on or after March 15, 2000, with earlier application permitted.

SAS No. 92, *Auditing Derivative Instruments, Hedging Activities, and Investments in Securities*

In September 2000 the ASB issued SAS No. 92, *Auditing Derivative Instruments, Hedging Activities, and Investments in Securities* (AICPA, *Professional Standards*, vol. 1, AU sec. 391). SAS No. 92 will help auditors plan and perform auditing procedures for financial statement assertions about derivative instruments, hedging activities, and investments in securities. SAS No. 92 will supersede SAS No. 81, *Auditing Investments* (AICPA, *Professional Standards*, vol. 1, AU sec. 332). SAS No. 92 is effective for audits of financial statements for fiscal years ending on or after June 30, 2001. Early application of the SAS is permitted. The ASB has also developed a companion Audit Guide to help practitioners implement the new SAS. This Audit Guide has been developed by the ASB and will be available in January 2001.

SAS No. 93, *Omnibus Statement on Auditing Standards—2000*

Issued by the ASB in October 2000, SAS No. 93—

1. Withdraws SAS No. 75, *Engagements to Apply Agreed-Upon Procedures to Specified Elements, Accounts, or Items of a Financial Statement* (AICPA, *Professional Standards*, vol. 1, AU sec. 622). The guidance in SAS No. 75 will be incorporated in Statement on Standards for Attestation Engagements (SSAE) No. 4, *Agreed-Upon Procedures Agreements* (AICPA, *Professional Standards*, vol. 1, AT sec. 600), to consolidate the guidance on agreed-upon procedures engagements in professional standards.

   The withdrawal of SAS No. 75 is concurrent with the effective date of SSAE No. 10, *Attestation Standards: Revision and Recodification*, scheduled to be issued in January 2001. SSAE No. 10 will be effective for agreed-upon procedures engagements for which the subject matter or assertion is as of or for a period ending on or after June 1, 2001, with earlier application permitted.

2. Amends SAS No. 58, *Reports on Audited Financial Statements*, to include an identification in the auditor's report of the country of origin of the accounting principles used to prepare the financial statements and the auditing standards that the auditor followed in performing the audit. This amendment withdraws Auditing Interpretation No. 13, "Reference to Country of Origin in the Auditor's Standard Report," of SAS No. 58, *Reports on Audited Financial Statements* (AICPA, *Professional Standards*, vol. 1, AU sec. 9508.53–.55). This amendment is effective for reports issued or reissued on or after June 30, 2001. Earlier application is permitted.

3. Amends SAS No. 84, *Communications Between Predecessor and Successor Auditors* (AICPA, *Professional Standards*, vol. 1, AU sec. 315), to clarify the definition of a predecessor auditor. This amendment is effective for audits of financial statements for periods ending on or after June 30, 2001. Earlier application is permitted.

Executive Summary—Auditing Standards

- SAS No. 88, *Service Organizations and Reporting on Consistency*—issued in December 1999, was effective upon issuance.
- SAS No. 89, *Audit Adjustments*—issued in December 1999, is effective for audits of financial statements for periods beginning on or after December 15, 1999, with earlier adoption permitted.
- SAS No. 90, *Audit Committee Communications*—issued in December 1999. The amendment to SAS No. 61 is effective for audits of financial statements for periods ending on or after December 15, 2000, with earlier application permitted. The amendment to SAS No. 71 is effective for reviews of interim financial information for interim periods ending on or after March 15, 2000, with earlier application permitted.
- SAS No. 91, *Federal GAAP Hierarchy*—issued in April 2000, this amendment to SAS No. 69 was effective upon issuance.
- SAS No. 92, *Auditing Derivative Instruments, Hedging Activities, and Investments in Securities*—issued in September 2000, is effective for audits of financial statements for fiscal years ending on or after June 30, 2001.
- SAS No. 93, *Omnibus Statement on Auditing Standards—2000*, was issued October 2000.
- SOP 00-1, *Auditing Health Care Third-Party Revenues and Related Receivables*, was issued in March this year.

Auditing Interpretations

Auditing Interpretations are issued by the Audit Issues Task Force of the ASB to provide timely guidance on the application of auditing pronouncements. Interpretations are reviewed by the ASB. An Interpretation is not as authoritative as a pronouncement of the ASB, but members should be aware that they may have to justify a departure from an interpretation if the quality of their work is questioned. The following is a list of some recently issued auditing interpretations.

- Interpretation No. 3, "Responsibilities of Service Organizations and Service Auditors With Respect to Information About the Year 2000 Issue in a Service Organization's

Description of Controls," of SAS No. 70, *Service Organizations* (AICPA, *Professional Standards*, vol. 1, AU sec. 9324.19–.31)

- Interpretation No. 13, "Reference to Country of Origin in the Auditor's Standard Report," of SAS No. 58, *Reports on Audited Financial Statements* (AICPA, *Professional Standards*, vol. 1, AU sec. 9508.53–.55)[26]
- Interpretation No. 7, "Management's and Auditor's Responsibilities With Regard to Related Party Disclosures Prefaced by Terminology Such As Management Believes That," of SAS No. 45, *Related Parties* (AICPA, *Professional Standards*, vol. 1, AU sec. 9334.22–.23)
- Auditing Interpretation, "The Meaning of the Term *Misstatement*" of SAS No. 47, *Audit Risk and Materiality in Conducting an Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 9312.01–.04)
- Auditing Interpretation, "Evaluating Differences in Estimates" of SAS No. 47, *Audit Risk and Materiality in Conducting an Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 9312.05–.09)
- Auditing Interpretation, "Quantitative Measures of Materiality in Evaluating Audit Findings" of SAS No. 47, *Audit Risk and Materiality in Conducting an Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 9312.10–.14)
- Auditing Interpretation, "Considering the Qualitative Characteristics of Misstatements" of SAS No. 47, *Audit Risk and Materiality in Conducting an Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 9312.15–.17)

Help Desk—The full text of these Interpretations can be obtained at the AICPA Web site at www.aicpa.org/members/div/auditstd/announce/index.htm.

26. Withdrawn by SAS No. 93. See the "Auditing Standards" section of this Alert for further information.

Attestation Standard

SSAE No. 10, *Attestation Standards: Revision and Recodification*

The ASB expects to issue SSAE No. 10, *Attestation Standards: Revision and Recodification*, in January 2001. SSAE No. 10 does the following:

- Changes the title of AT section 101 to *Attest Engagements*
- Changes the definition of an attest engagement into a statement of applicability of the standard, as follows:

  > This statement applies to engagements in which a certified public accountant in the practice of public accounting (hereinafter referred to as a *practitioner*) is engaged to issue or does issue an examination, a review or an agreed-upon procedures report on subject matter, or an assertion about the subject matter, that is the responsibility of another party.

- Revises the third general standard to focus on the essential elements of criteria: The criteria must be suitable and must be available to users. The subject matter also must be capable of reasonably consistent evaluation against the criteria.
- Enables true direct reporting on subject matter by eliminating the requirement to make reference to the assertion in the practitioner's report.
- Provides expanded guidance on the circumstances in which the use of attest reports should be restricted to specified parties.
- Supersedes SSAE Nos. 1 through 9.

The new standard also revises and renumbers the AT sections.

The new SSAE also eliminates the requirement in AT section 201, *Agreed-Upon Procedures Engagements*, for the practitioner to obtain a written assertion in an agreed-upon procedures attest engagement. It also incorporates changes needed as a result of the withdrawal of SAS No. 75, *Engagements to Apply Agreed-Upon Procedures to Specified Elements, Accounts, or Items of a Financial Statement*. That withdrawal is reflected in SAS No. 93, *Omnibus Statement on Auditing Standards—2000*.

SSAE No. 10 is effective when the subject matter or assertion is as of or for a period ending on or after June 1, 2001. Early application is permitted.

> **Help Desk**—Look for a new AICPA Practice Aid on how to understand and apply the provisions of SSAE No. 10. It is expected to become available during the first quarter of 2001.

New GAAP Pronouncements

What new accounting pronouncements have been issued this year?

In this section we present either brief summaries or a listing of accounting pronouncements issued since the publication of last year's Alert. The summaries are for informational purposes only and should not be relied on as a substitute for a complete reading of the applicable standard. For information on accounting standards issued subsequent to the writing of this Alert, please refer to the Web sites provided throughout this section. You may also look for announcements of newly issued standards in the *CPA Letter* and the *Journal of Accountancy*.

FASB Pronouncements

FASB Statement No. 138, *Accounting for Certain Derivative Instruments and Certain Hedging Activities*

FASB Statement No. 138 addresses a limited number of issues causing implementation difficulties for numerous entities that apply FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities*. This Statement amends the accounting and reporting standards of FASB Statement No. 133 for certain derivative instruments and certain hedging activities as indicated in the following paragraphs.

1. The normal purchases and normal sales exception in paragraph 10(b) may be applied to contracts that implicitly or explicitly permit net settlement, as discussed in paragraphs 9(a) and 57(c)(1), and contracts that have a market

mechanism to facilitate net settlement, as discussed in paragraphs 9(b) and 57(c)(2).

2. The specific risks that can be identified as the hedged risk are redefined so that in a hedge of interest-rate risk, the risk of changes in the benchmark interest rate (benchmark interest rate is defined in paragraph 4(jj) of FASB Statement No. 138) would be the hedged risk.

3. Recognized foreign-currency-denominated assets and liabilities for which a foreign currency transaction gain or loss is recognized in earnings under the provisions of paragraph 15 of FASB Statement No. 52, *Foreign Currency Translation*, may be the hedged item in fair value hedges or cash flow hedges.

4. Certain intercompany derivatives may be designated as the hedging instruments in cash flow hedges of foreign currency risk in the consolidated financial statements if those intercompany derivatives are offset by unrelated third-party contracts on a net basis.

FASB Statement No. 138 also amends FASB Statement No. 133 for decisions made by the FASB relating to the Derivatives Implementation Group (DIG) process. Certain decisions arising from the DIG process that required specific amendments to FASB Statement No. 133 are incorporated into FASB Statement No. 138.

FASB Statement No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*

Issued in September 2000, FASB Statement No. 140 replaces FASB Statement No. 125, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*. It revises the standards for accounting for securitizations and other transfers of financial assets and collateral and requires certain disclosures, but it carries over most of FASB Statement No. 125's provisions without reconsideration.

The Statement provides accounting and reporting standards for transfers and servicing of financial assets and extinguishments of liabilities. Those standards are based on consistent application of a *financial-components approach* that focuses on control. Under that approach, after a transfer of financial assets, an entity recognizes the financial and servicing assets it controls and the liabilities it has incurred, derecognizes financial assets when control has been surrendered, and derecognizes liabilities when extinguished. Statement No. 140 provides consistent standards for distinguishing transfers of financial assets that are sales from transfers that are secured borrowings.

A transfer of financial assets in which the transferor surrenders control over those assets is accounted for as a sale to the extent that consideration other than beneficial interests in the transferred assets is received in exchange. The transferor has surrendered control over transferred assets if and only if all of the following conditions are met:

1. The transferred assets have been isolated from the transferor—put presumptively beyond the reach of the transferor and its creditors, even in bankruptcy or other receivership.
2. Each transferee (or, if the transferee is a qualifying special-purpose entity (SPE), each holder of its beneficial interests) has the right to pledge or exchange the assets (or beneficial interests) it received, and no condition both constrains the transferee (or holder) from taking advantage of its right to pledge or exchange and provides more than a trivial benefit to the transferor.
3. The transferor does not maintain effective control over the transferred assets through either (a) an agreement that both entitles and obligates the transferor to repurchase or redeem them before their maturity or (b) the ability to unilaterally cause the holder to return specific assets, other than through a cleanup call.

FASB Statement No. 140 requires that liabilities and derivatives incurred or obtained by transferors as part of a transfer of financial assets be initially measured at fair value, if practicable. It also requires that servicing assets and other retained interests in the transferred assets be measured by allocating the previous carrying amount between the assets sold, if any, and retained interests, if any, based on their relative fair values at the date of the transfer.

The Statement requires that servicing assets and liabilities be subsequently measured by (a) amortization in proportion to and over the period of estimated net servicing income or loss and (b) assessment for asset impairment or increased obligation based on their fair values.

The Statement requires that a liability be derecognized if and only if either (a) the debtor pays the creditor and is relieved of its obligation for the liability or (b) the debtor is legally released from being the primary obligor under the liability either judicially or by the creditor. Therefore, a liability is not considered extinguished by an in-substance defeasance.

The Statement provides implementation guidance for assessing isolation of transferred assets; conditions that constrain a transferee; conditions for an entity to be a qualifying SPE; accounting for transfers of partial interests; measurement of retained interests; servicing of financial assets; securitizations, transfers of sales-type and direct financing lease receivables; securities lending transactions; repurchase agreements, including "dollar rolls," "wash sales," loan syndications, and participations; risk participations in banker's acceptances; factoring arrangements; transfers of receivables with recourse; and extinguishments of liabilities. The Statement also provides guidance about whether a transferor has retained effective control over assets transferred to qualifying SPEs through removal-of-accounts provisions, liquidation provisions, or other arrangements.

The Statement requires a debtor to (a) reclassify financial assets pledged as collateral and report those assets in its statement of financial position separately from other assets not so encumbered if the secured party has the right by contract or custom to sell or repledge the collateral and (b) disclose assets pledged as collateral that have not been reclassified and separately reported in the statement of financial position. The Statement also requires a secured party to disclose information about collateral that it has accepted and is permitted by contract or custom to sell or repledge.

The required disclosure includes the fair value at the end of the period of that collateral, and of the portion of that collateral that it has sold or repledged, and information about the sources and uses of that collateral.

The Statement requires an entity that has securitized financial assets to disclose information about accounting policies, volume, cash flows, key assumptions made in determining fair values of retained interests, and sensitivity of those fair values to changes in key assumptions. It also requires that entities that securitize assets disclose for the securitized assets and any other financial assets it manages together with them (a) the total principal amount outstanding, the portion that has been derecognized, and the portion that continues to be recognized in each category reported in the statement of financial position, at the end of the period; (b) delinquencies at the end of the period; and (c) credit losses during the period.

In addition to replacing FASB Statement No. 125 and rescinding FASB Statement No. 127, *Deferral of the Effective Date of Certain Provisions of FASB Statement No. 125*, FASB Statement No. 140 carries forward the actions taken by FASB Statement No. 125. FASB Statement No. 125 superseded FASB Statement Nos. 76, *Extinguishment of Debt*, and 77, *Reporting by Transferors for Transfers of Receivables with Recourse*. FASB Statement No. 125 amended FASB Statement No. 115, *Accounting for Certain Investments in Debt and Equity Securities*, to clarify that a debt security may not be classified as held-to-maturity if it can be prepaid or otherwise settled in such a way that the holder of the security would not recover substantially all of its recorded investment. FASB Statement No. 125 amended and extended to all servicing assets and liabilities the accounting standards for mortgage servicing rights now in FASB Statement No. 65, *Accounting for Certain Mortgage Banking Activities*, and superseded FASB Statement No. 122, *Accounting for Mortgage Servicing Rights*. FASB Statement No. 125 also superseded FASB Technical Bulletins No. 84-4, *In-Substance Defeasance of Debt*, and No. 85-2, *Accounting for Collateralized Mortgage Obligations (CMOs)*, and amended FASB Technical Bulletin No. 87-3, *Accounting for Mortgage Servicing Fees and Rights*.

FASB Statement No. 125 was effective for transfers and servicing of financial assets and extinguishments of liabilities occurring after December 31, 1996, and on or before March 31, 2001, except for certain provisions. FASB Statement No. 127 deferred until December 31, 1997, the effective date (a) of paragraph 15 of FASB Statement No. 125 and (b) for repurchase agreement, dollar-roll, securities lending, and similar transactions, of paragraphs 9 through 12 and 237(b) of FASB Statement No. 125.

FASB Statement No. 140 is effective for transfers and servicing of financial assets and extinguishments of liabilities occurring after March 31, 2001. The Statement is effective for recognition and reclassification of collateral and for disclosures relating to securitization transactions and collateral for fiscal years ending after December 15, 2000. Disclosures about securitization and collateral accepted need not be reported for periods ending on or before December 15, 2000, for which financial statements are presented for comparative purposes.

FASB Statement No. 140 is to be applied prospectively with certain exceptions. Other than those exceptions, earlier or retroactive application of its accounting provisions is not permitted.

FASB Interpretation No. 44, *Accounting for Certain Transactions Involving Stock Compensation*[27]

APB Opinion No. 25, *Accounting for Stock Issued to Employees*, was issued in October 1972. Since its issuance, questions have been raised about its application, and diversity in practice has developed. During its consideration of the accounting for stock-based compensation, which led to the issuance of FASB Statement No. 123, *Accounting for Stock-Based Compensation*, the FASB decided not to address practice issues related to APB Opinion 25 because it had planned to supersede the Opinion. However, FASB Statement No. 123 permits entities to continue applying APB Opinion 25 to stock compensation involving

27. Certain implementation issues regarding FASB Interpretation No. 44, as well as certain issues regarding the application of APB Opinion 25 that are not addressed by Interpretation No. 44, are being addressed by the EITF in Issue No. 00-23.

employees. Consequently, questions remain about the application of APB Opinion 25 in a number of different circumstances.

Interpretation No. 44 clarifies the application of APB Opinion 25 for only certain issues. It does not address any issues related to the application of the fair value method in FASB Statement No. 123. The issues addressed in Interpretation No. 44 were selected after receiving input from members of both the FASB EITF and the task force on stock compensation that assisted in the development of FASB Statement 123. Among other issues, Interpretation No. 44 clarifies—

1. The definition of employee for purposes of applying APB Opinion 25.
2. The criteria for determining whether a plan qualifies as a noncompensatory plan.
3. The accounting consequence of various modifications to the terms of a previously fixed stock option or award.
4. The accounting for an exchange of stock compensation awards in a business combination.

In considering those issues, the FASB focused on interpreting APB Opinion 25. The FASB decided not to amend the APB Opinion 25 framework because most of the problems inherent in the APB Opinion 25 intrinsic value method are addressed in Statement 123 through that Statement's recommended fair value method. Consequently, in determining the guidance in this Interpretation, the FASB reached its conclusions within the framework of APB Opinion 25 and did not refer to concepts underlying the fair value method described in FASB Statement No. 123.

Interpretation No. 44 is effective July 1, 2000, but certain conclusions in the Interpretation cover specific events that occur after either December 15, 1998, or January 12, 2000. To the extent that the Interpretation covers events occurring during the period after December 15, 1998, or January 12, 2000, but before the effective date of July 1, 2000, the effects of applying the Interpretation are recognized on a prospective basis from July 1, 2000.

Executive Summary—FASB Pronouncements

- FASB Statement No. 138, *Accounting for Certain Derivative Instruments and Certain Hedging Activities*, an amendment of FASB Statement No. 133
- FASB Statement No. 139, *Recission of FASB Statement No. 53 and Amendments to FASB Statements No. 63, 89, and 121*
- FASB Statement No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*, a replacement of FASB Statement No. 125
- FASB Interpretation No. 44, *Accounting for Certain Transactions Involving Stock Compensation*—an interpretation of APB Opinion No. 25
- For a summary of all the FASB Statements listed here, visit the FASB Web site at www.fasb.org.

Accounting Statement of Position[28]

The following is an accounting SOP issued this year. For a complete summary of all the AICPA SOPs issued this year, see *Audit Risk Alert 2000/01* (Product No. 022260kk).

- SOP 00-2, *Accounting by Producers or Distributors of Films*

    Help Desk—AICPA staff, helped by industry experts, has released technical questions and answers (Q&As) on financial accounting and reporting issues related to SOP 00-2. You can find the Q&As in the accounting standards part of the AICPA Web site at www.aicpa.org/members/div/acctstd/general/othitem.htm

EITF Consensus Positions

The EITF was established by the FASB in July 1984 to assist in improving financial reporting through the timely identification, discussion, and resolution of financial issues within the framework of existing authoritative literature. The application of EITF consensuses (category c of the GAAP hierarchy) effective after

28. SOP 00-1, *Auditing Health Care Third-Party Revenues and Related Receivables*, which was issued under the authority of the ASB, is listed in the "New Auditing and Attestation Pronouncements" section of this Alert.

March 15, 1992, is mandatory under SAS No. 69, *The Meaning of* Present Fairly in Conformity With Generally Accepted Accounting Principles *in the Independent Auditor's Report*. Any EITF consensus issued before March 16, 1992, becomes effective in the hierarchy for initial application of an accounting principle after March 15, 1993. The EITF meets approximately every eight weeks. All meetings are announced by the FASB in its *Action Alert*, together with a listing of the topics on the meeting agenda.

The following lists certain of the EITF issues discussed from November 1999 through the September 2000 meetings[29] that may affect auto dealerships.

EITF Issue No.	*Description*	*Date of Consensus/Status*
99-19	*Reporting Revenue Gross as a Principal versus Net as an Agent*	Originally discussed March 16, 2000. Consensus was reached July 19–20, 2000.
00-2	*Accounting for Web Site Development Costs*	Originally discussed January 19–20, 2000. Consensuses were reached March 16, 2000.
00-10	*Accounting for Shipping and Handling Fees and Costs*	Originally discussed May 17–18, 2000. Consensuses were reached July 19–20, 2000, and September 20–21, 2000.
00-14	*Accounting for Certain Sales Incentives*	Consensuses were reached May 17–18, 2000. Revisions were made to the Abstracts, September 20–21, 2000.
00-21	*Accounting for Multiple-Element Revenue Arrangements*	Originally discussed July 19–20, 2000. Further discussion is planned.
00-22	*Accounting for "Points" and Certain Other Time-Based or Volume-Based Sales Incentive Offers, and Offers for Free Products or Services to Be Delivered in the Future*	Originally discussed September 20–21, 2000. Further discussion is planned.

(continued)

29. This table reflects information contained in the minutes to the September 2000 EITF meeting. Look to *EITF Abstracts* for final language. *Abstracts* can be ordered directly from the FASB (www.fasb.org).

EITF Issue No.	*Description*	*Date of Consensus/Status*
00-23	*Issues Related to the Accounting for Stock Compensation under APB Opinion No. 25 and FASB Interpretation No. 44*	Originally discussed September 20–21, 2000. Consensuses reached on certain issues. Further discussion is planned.
00-24	*Revenue Recognition: Sales Arrangements That Include Specified-Price Trade-in Rights*	Originally discussed September 20–21, 2000. Further discussion is planned.
00-25	*Accounting for Consideration from a Vendor to a Retailer in Connection with the Purchase or Promotion of the Vendor's Products*	Originally discussed September 20–21, 2000. Further discussion is planned.

AICPA Professional Ethics Rulings and Interpretations

It is important for you to monitor the activities of the Professional Ethics Executive Committee because they may issue interpretations, ethics rulings, or both, that may be relevant to you. See the *Audit Risk Alert 2000/01* (Product No. 022260kk) for a summary of recent activities.

Help Desk—For full information about the interpretations and rulings, visit the Professional Ethics Team Web page at www.aicpa.org/members/div/ethics/index.htm. You can also call the Professional Ethics Team at (888) 777-7077, menu option 2, followed by menu option 2.

On the Horizon

What exposure drafts are currently outstanding?

Practitioners should note that the purpose of exposure drafts is to solicit comments from preparers, auditors, users of financial statements, and other interested parties. They are nonauthoritative and cannot be used as a basis for changing GAAS or GAAP. The following is a listing of some of the more significant exposure drafts outstanding at the time this Alert was written. Please note that AICPA standard-setting committees are now publishing exposure drafts of proposed professional standards exclusively on the AICPA's Web site.

ASB Exposure Draft

Issued in October 2000, the proposed SAS amends SAS No. 55, *Consideration of Internal Control in a Financial Statement Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 319), as amended by SAS No. 78, *Consideration of Internal Control in a Financial Statement Audit: An Amendment to Statement on Auditing Standards No. 55* (AICPA, *Professional Standards*, vol. 1, AU sec. 319), to provide guidance to auditors about the effect of information technology (IT) on internal control, and on the auditor's understanding of internal control and assessment of control risk. The ASB believes the guidance is needed because entities of all sizes increasingly are using IT in ways that affect their internal control and the auditor's consideration of internal control in a financial statement audit. Consequently, in some circumstances, auditors may need to perform tests of controls to perform effective audits.

This proposed SAS amends SAS No. 55, as amended by SAS No. 78, to—

1. Incorporate and expand on the concept from SAS No. 80, *Amendment to Statement on Auditing Standards No. 31*, Evidential Matter (AICPA, *Professional Standards*, vol. 1, AU sec. 326.14), that in circumstances where a significant amount of information supporting one or more financial statement assertions is electronically initiated, recorded, processed, and reported, the auditor may determine that it is not practical or possible to restrict detection risk to an acceptable level by performing only substantive tests for one or more financial statement assertions. In such circumstances, the auditor should obtain evidential matter about the effectiveness of both the design and operation of controls to reduce the assessed level of control risk.
2. Describe how IT may affect internal control, evidential matter, and the auditor's understanding of internal control and assessment of control risk.

3. Describe both benefits and risks of IT to internal control, and how IT affects the components of internal control, particularly the control activities and information and communication components.
4. Provide guidance to help auditors determine whether specialized skills are needed to consider the effect of computer processing on the audit, to understand the controls, or to design and perform audit procedures.
5. Clarify that in obtaining an understanding of the entity's financial reporting process, the auditor should understand how both standard, recurring entries and nonstandard, nonrecurring entries are initiated and recorded, and the auditor should also understand the controls that have been placed in operation to ensure that such entries are authorized, complete, and correctly recorded.
6. Update terminology and references to IT systems and controls.

The proposed SAS does not—

1. Eliminate the alternative of assessing control risk at the maximum level and performing a substantive audit, if that is an effective approach.
2. Change the requirement to perform substantive tests for significant account balances and transaction classes.

> **Help Desk**—See the ASB exposure drafts Web site at www.aicpa.org/members/div/auditstd/drafts.htm for information on the status of these and other exposure drafts issued by the ASB. Note that the AICPA's standard-setting committees are now publishing exposure drafts of proposed professional standards exclusively on the AICPA Web site. The AICPA will notify interested parties by e-mail about new exposure drafts. To have your e-mail address put on the notification list for all AICPA exposure drafts, send your e-mail address to memsat@aicpa.org. Indicate "exposure draft email list" in the subject header field to help process the submissions more efficiently. Include your full name, mailing address and, if known, your membership and subscriber number in the message.

FASB Statement Exposure Drafts

- Proposed Statement of Financial Accounting Standards—*Accounting for the Impairment or Disposal of Long-Lived Assets and for Obligations Associated with Disposal Activities*, July 12, 2000
- Proposed Statement of Financial Accounting Standards—*Accounting for Obligations Associated with the Retirement of Long-Lived Assets*, February 17, 2000
- Proposed Statement of Financial Accounting Standards—*Business Combinations and Intangible Assets*; September 7, 1999
- Proposed Statement of Financial Accounting Standards—*Consolidated Financial Statements: Purpose and Policy*, February 23, 1999

  Help Desk—See the FASB Web site www.rutgers.edu/Accounting/raw/fasb/draft/draftpg.html for information on the status of these and other exposure drafts issued by the FASB.

AcSEC Exposure Drafts

- Proposed SOP—*Accounting for Discounts Related to Credit Quality*, December 30, 1998 (The final SOP is expected to be titled "Accounting for Certain Purchased Loans.")
- Proposed SOP—*Amendment to Scope of SOP 95-2*, Financial Reporting by Nonpublic Investment Partnerships, *to Include Commodity Pools*, August 15, 2000
- Proposed SOP—*Accounting by Certain Financial Institutions and Entities That Lend to or Finance the Activities of Others*, May 30, 2000
- Proposed SOP—*Accounting by Insurance Enterprises for Demutualizations and Formations of Mutual Insurance Holding Companies and for Certain Long-Duration participating Contracts*, April 3, 2000

- Proposed SOP—*Accounting for and Reporting of Certain Health and Welfare Benefit Plan Transactions*, March 22, 2000

  Help Desk—See the AcSEC exposure draft Web site at http:/www.aicpa.org/members/div/acctstd/edo/index.htm for information on the status of these and other exposure drafts issued by AcSEC.

Professional Ethics Executive Committee Exposure Drafts

On April 15, 2000, the Professional Ethics Division issued an exposure draft, *Omnibus Proposal of Professional Ethics Division Interpretations and Rulings*, containing proposed revisions to four ethics pronouncements:

1. Interpretation 101-11 under rule 101, "Independence and the Performance of Professional Services Under the Statements on Standards for Attestation Engagements and Statement on Auditing Standards No. 75, Engagements to Apply Agreed-Upon Procedures to Specified Elements, Accounts, or Items of a Financial Statement"
2. Ruling 100 under rule 101, "Actions Permitted When Independence Is Impaired"
3. Ruling 108 under rule 101, "Participation of Member, Spouse or Dependent in Retirement, Savings, or Similar Plan Sponsored by, or That Invest in, Client"
4. Interpretation 501-5 under rule 501, "Failure to Follow Requirements of Government Bodies, Commissions, or Other Regulatory Agencies in Performing Attest or Similar Services"

   Help Desk—See the AICPA Professional Ethics Web site www.aicpa.org/members/div/ethics/index.htm for information on the status of these and other exposure drafts along with other ethics related matters.

Beyond the Audit

Assurance Services

What are Assurance Services Alerts?

As discussed in last year's Alert, the AICPA's Accounting and Auditing Publications Team has introduced a new series titled Assurance Services Alerts. The Alerts in this series serve both as an introduction to those who are unfamiliar with these emerging services and an update of important new developments for those who have expanded their practice to include such engagements. The premier entrants to the series were *CPA ElderCare* and *WebTrust*^{SM}. We're pleased to announce that a third Alert has been added to the series, *CPA SysTrust*^{SM}.

This year's Assurance Services Alerts, *CPA ElderCare Services—2000, WebTrust—2000*^{SM}, and *CPA SysTrust*^{SM}*—2000* explain, among other things—

- The nature and purpose of these new services.
- How to get started.
- Applicable professional standards.
- Sources of additional information.
- Recent practice and industry developments.

The information provided in these Alerts will assist you in ensuring your long-term professional growth by tapping into the full potential of *CPA ElderCare*, *WebTrust* and *CPA SysTrust* services. See "Resource Central" later in this Alert for order information.

CPA Performance View^{SM} Services

CPA Performance View is a recently introduced assurance service developed by the AICPA under the direction of the Business Performance Measures Task Force and the Assurance Services Executive Committee.

The CPA Performance View process is a new way for CPAs to assist clients in managing their businesses more efficiently and effectively. It also allows CPAs to change their role from that of a financial adviser to one of a strategic business adviser and to become an integral part of the growth of your clients' businesses. This service is the CPA-branded delivery of performance measurement consulting services that will allow CPAs to provide a new service to their clients.

Performance measurement is defined as the identification of critical success factors that lead to measures that can be tracked over time to assess progress made in achieving specific targets linked to an entity's vision. The measures track aspects of the entire business—both financial and nonfinancial (for example, customer satisfaction, employee training and satisfaction, product quality, sales calls, and proposals delivered). The theory behind performance measurement is not a new fad; it has been around for a while and is at the core of other management methodologies, such as economic value added, market value added, the Dupont model, and the balanced scorecard.

CPA Performance View services focus on paring down the information management sees to selected key performance indicators that will help them make better decisions. By focusing on the key performance indicators, management will be able to stay on course with the organization's strategy and easily determine the organization's overall performance. Performance measures have a direct correlation to company goals and serve as leading (future-oriented) indicators rather than the usual lagging-indicators (for example, last quarter's income or revenues). The use of performance measures allows companies to provide a clear link between compensation and performance and can be used as a means to motivate employees. It also communicates the organization's goals and strategies to employees at all levels of the organization.

As the CPA Performance View service provides management with better information that will lead to better decisions, clients will come to rely more and more on their CPA to provide value-added services and advice. Guidance on expanding your practice to include this new service can be found in the AICPA Practice Aid

CPA Performance View: A Practitioner's Guide to Providing Performance Measurement Engagements (Product No. 006606kk).

Resource Central

AICPA—At Your Service

How can I order AICPA products? What other AICPA services may be of interest to me?

For a complete listing of AICPA services, see *Audit Risk Alert 2000/2001* (Product No. 022260kk)

Order Department (Member Satisfaction)

To order AICPA products, call (888) 777-7077; write AICPA Order Department, CLA10, P.O. Box 2209, Jersey City, NJ 07303-2209; fax (800) 362-5066. For best results, call Monday through Friday between 8:30 A.M. and 7:30 P.M. EST. You can obtain product information and place online orders at the AICPA's Web site, www.aicpa.org. (Copies of FASB publications referred to in this document may be obtained directly from the FASB by calling the FASB Order Department at (203) 847-0700, ext. 10.)

Accounting and Auditing Technical Hotline

The AICPA Technical Hotline answers members' inquiries about accounting, auditing, attestation, compilation, and review services. Call (888) 777-7077.

New! Online CPE Offer!

The AICPA has launched a new online learning tool, AICPA InfoBytes. An annual fee ($95 for members and $295 for nonmembers) will offer unlimited access to over 1,000 hours of online CPE in one- and two-hour segments. Register today as our guest at infobytes.aicpaservices.org.

National Auto Dealership Conference

Each fall the AICPA sponsors a National Auto Dealership Conference that is specifically designed to update auditors and dealers on significant accounting, auditing, legal, financial, and tax developments affecting the auto dealership industry. Information on the conference may be obtained by calling the AICPA Conferences Division at (201) 938-3556.

....

This Audit Risk Alert replaces *Auto Dealership Industry Developments—1999/2000*

The Audit Risk Alert *Auto Dealership Industry Developments* is published annually. As you encounter audit and industry issues that you believe warrant discussion in next year's Alert, please feel free to share them with us. Any other comments that you have about the Alert would also be greatly appreciated. You may e-mail your comments to ldelahanty@aicpa.org or write to:

Linda C. Delahanty
AICPA
Harborside Financial Center
201 Plaza Three
Jersey City, NJ 07311-3881

APPENDIX

Federal Money Laundering Regulations

The Bank Secrecy Act (BSA), enacted to address the problem of money laundering, authorizes the U.S. Department of the Treasury to issue regulations requiring bank and non-bank financial institutions to file reports, keep certain records, implement anti-money laundering programs and compliance procedures, and report suspicious transactions to the government (see 31 CFR Part 103). Failure to comply with BSA reporting and recordkeeping provisions may result in the assessment of severe criminal and civil penalties. Automobile dealerships are defined as financial institutions under the Act (Title 31 USC 5312(a)(5312(a)(2)(T) but are not currently subject to BSA rules. IRS regulations require dealerships to file reports for cash (and certain cash equivalents) transactions greater than $10,000 (26 USC 6050I). Cash transactions conducted by or on behalf of the same customer in a twenty-four-hour period must be aggregated and, if the cash transactions exceed $10,000, must be reported. In addition, multiple cash transactions conducted over the course of a rolling one-year period, by or on behalf of the same person, must also be aggregated and reported if the dealership knows or has reason to know that the transactions are related.

As with the BSA, structuring transactions to avoid reporting is prohibited, and wilful failure to file a Form 8300 or to file incorrectly may result in severe criminal and civil penalties.

BSA rules governing the reporting of international transportation of currency or monetary instruments (CMIRs—Customs Form 4790) have not been modified since 1989, and foreign bank and financial accounts (FBARs—Treasury Form TDF 90-22.1) have not been modified since 1987. However, on January 16, 1997 (see the *Federal Register*), the Treasury issued a proposal to expand the statutory definition of monetary instruments to include foreign bank drafts.

According to the National Association of Attorneys General, thirty-three states, the District of Columbia, and Puerto Rico have imposed criminal penalties for money laundering offenses.

For copies of BSA forms mentioned in this appendix and more information regarding anti-money laundering issues, consult the FinCEN Web site at www.treas.gov/fincen.

INFORMATION SOURCES

Organization	*General Information*	*Fax Services*	*Electronic Bulletin Board Services*
American Institute of Certified Public Accountants	*Order Department (Member Satisfaction)* Harborside Financial Center, 201 Plaza Three, Jersey City, NJ 07311-3881 (888) 777-7077	*24 Hour Fax Hotline* (201) 938-3787	Internet address— www.aicpa.org
Financial Accounting Standards Board	*Order Department* P.O. Box 5116 Norwalk, CT 06856-5116 (203) 847-0700, ext. 10		Internet address— www.fasb.org
National Automobile Dealers Association[1]	8400 Westpark Drive McLean, VA 22102 (703) 821-7000		Internet address— www.nada.org
American International Auto Dealers Association[2]	99 Canal Center Plaza Alexandria, VA 22314-1538		

State and regional not-for-profit organizations promoting the interests of automobile dealerships can be found in most states. These organizations generally stay abreast of state and local legislative issues and communicate these issues to their membership through newsletters.

1. The NADA is a not-for-profit organization promoting the interests of franchised new car and truck dealers in the United States. The NADA publishes economic newsletters, a monthly magazine, used car valuation guides, and other information on various aspects of dealerships.

2. The American International Auto Dealers Association is an organization promoting the interests of foreign franchises.

022254